

Report
of the
Advisory Panel on Efficiencies

Submitted to Sheridan Scott, Commissioner of Competition
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About the panellists

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Executive summary

In September 2004, the Competition Bureau launched national consultations on the role of efficiency gains in merger review under the *Competition Act*. One element of the process was the appointment of the Advisory Panel on Efficiencies. The Panel's mandate was to assess the role that efficiency gains stemming from mergers should play in the review process, in the context of Canada's evolving economy. The Panel was asked to consider the general economic and business implications of the current treatment of efficiency gains, and comment on the characteristics that Canadian competition policy should have to ensure that efficiency gains are properly addressed. Throughout, particular attention was to be paid to dynamic efficiency.

The Advisory Panel met regularly from January to May 2005. It reviewed the literature on the efficiency defence and on productivity in Canada. It also analyzed the treatment of efficiency gains in competition policies in other countries.

The role of efficiency gains in Canadian competition policy traces back to a 1969 Economic Council of Canada report that noted that small market size often resulted in inadequately specialized Canadian firms with short production runs. At the time, tariff barriers sheltered Canada's domestic market from foreign competition and free trade was an unrealistic option. The Council therefore recommended that Canada's competition law and policy specifically take into account the efficiency gains that could result from mergers that otherwise could be deemed to be uncompetitive.

The current Panel addressed its mandate by asking three questions. First, what was the Economic Council's rationale for recommending in 1969 that efficiency gains be given specific consideration as an "offsetting public benefit"? Second, is this consideration still warranted today, given the evolution of the Canadian economy? Third, if specific consideration of efficiency gains is still warranted, what should characterize their treatment in the *Competition Act*?

The existing merger efficiency defence became part of Canada's competition law when the *Competition Act* was enacted in 1986. Section 96 of the Act allows the Competition Tribunal to authorize a merger that has brought about or is likely to bring about gains in efficiency that "will be greater than, and will offset, the effects of any prevention or lessening of competition" resulting from the merger.

Only 35 of the more than 4000 mergers the Competition Bureau has reviewed since 1986 have come before the Tribunal, and of these only a handful have been substantively litigated. There appears to be a strong disincentive for parties to vigorously present claims about efficiency gains to the Bureau, since relying on an efficiency defence not only introduces a long and uncertain litigious process but may also be viewed as an implicit or explicit admission that a merger substantially lessens competition. The Panel concludes that while efficiency gains have not been entirely ignored, they have not been a regular or explicit consideration in merger review.

In its review of economic changes since 1969, the Panel concluded that Canada now has a very open economy, with one of the highest levels of trade intensity among member countries of the Organisation for Economic Co-operation and Development. Nonetheless, non-tariff barriers to trade still have a significant impact on productivity, and thus the Economic Council's 1969

concerns about inefficiency are still valid, particularly for services. Therefore, competition policy can still play a role in bringing about more efficiency and innovation in the economy.

At the same time, competition policy by itself may not have a predictable and replicable impact on innovative capacity. In some cases, a merged firm's larger scale — and the resulting higher concentration in an industry — may lead to more innovation and benefit the economy; in other cases, increased concentration may have a negative effect. A one-size-fits-all approach to enhancing dynamic efficiency through competition policy will not work.

The Panel's mandate required it to review the Competition Bureau's October 2004 report of the round table it held with competition law authorities from Australia, Canada, the European Union, Mexico, the United Kingdom and the United States. Officials in other countries entertain dynamic efficiency claims in merger review, but do so with caution. The Panel concluded that, although convergence of Canadian laws with those of other major jurisdictions is generally good public policy, Canada should not refrain from adopting a unique approach when the situation demands it.

The Panel, following its review, concluded the following.

- Despite significant changes to the Canadian economy, Canada still faces a major productivity problem. Thus, public policy tools, including competition policy, should all be considered to promote economic efficiency.
- Mergers can contribute to improvements in the efficiency of firms; therefore, merger review should involve explicit consideration of potential efficiency gains.
- There may be special circumstances in which competitive market forces have not resulted in the optimal efficiency of firms, circumstances that might justify a merger that substantially lessens or prevents competition to proceed on the basis that it will produce sufficient offsetting efficiency gains. However, the circumstances in which an efficiency defence may apply, and the applicable standards, should be more clearly defined.
- An efficiency defence should not be permitted in the case of a merger-to-monopoly.

The Panel believes that Canada should retain an efficiency defence, because in rare but important cases, a trade-off between efficiency gains and a substantial lessening or prevention of competition may be justified. Both productive and dynamic efficiency gains should be considered in this analysis. In coming to these conclusions, the Panel also notes the following.

- There should be a clear, predictable and politically acceptable standard that the Tribunal applies when weighing efficiency gains.
- The current standard for weighing efficiency gains against competition effects is not satisfactory. Parliament should therefore define the standard that any trade-off would have to meet, since this is fundamentally a policy question of who should benefit from the efficiency gains of an otherwise anti-competitive merger.
- The existence of an efficiency defence, which is likely to apply rarely, should not detract from the Competition Bureau and Tribunal regularly considering pro-competitive efficiency gains when assessing the competitive effects of a merger.

With respect to the characteristics that the Canadian competition policy framework should have in order to ensure that efficiency gains are properly addressed, the Panel notes the importance of the following.

- *Oversight.* The Tribunal's review function would be even more important under the Panel's proposed framework, since the Bureau would more regularly assess claims of efficiency gains.
- *Accessibility.* Parties should be able to bring their claims of efficiency gains to the Bureau at the outset of a review and, in doing so, should not be assumed to be explicitly or implicitly admitting that their merger creates a competition problem.
- *Predictability.* Businesses and their advisors consider it critically important to be able to predict with some degree of certainty the likely outcome of a Bureau merger review.
- *Assessing dynamic efficiency.* While competition policy should recognize claims of dynamic efficiency gains, measurement problems preclude such claims being given special weight or time frames. The current practice of a qualitative assessment of claims of dynamic efficiency gains is appropriate and consistent with international practice.

The Panel was also asked to consider the applicability of its findings in the context of strategic alliances. Here, the Panel concluded that strategic alliances are very similar to mergers and that the regime for dealing with efficiency gains in strategic alliances should be identical to that in place for mergers.

Chapter 1

The Advisory Panel on Efficiencies

In September 2004, the Competition Bureau launched national consultations on the role of efficiencies under the *Competition Act*. The consultations involved three elements. First, the Bureau issued a consultation paper entitled *The Treatment of Efficiencies in the Competition Act* (Canada 2004a). Stakeholders were invited to submit their views on this paper in writing and during round-table sessions in Vancouver, Toronto and Montréal. Second, in October 2004, the Bureau held an international round table with participants from the competition law enforcement authorities of several jurisdictions. Finally, in January 2005, the Bureau appointed the Advisory Panel on Efficiencies to provide an expert opinion on various economic and public policy issues surrounding the treatment of efficiencies in merger review and to prepare an independent report.

The Panel's mandate was as follows.

The mandate of the Advisory Panel on Efficiencies is to assess the role that efficiencies should play in the administration and enforcement of the *Competition Act* (Act) in the context of Canada's evolving economy. In doing this assessment, it will consider the general economic and business implications of the current treatment of efficiencies under the Act, and comment on the characteristics that the Canadian competition policy framework should have, in order to ensure that efficiencies are properly addressed. This mandate is focussed on the treatment of efficiencies under the merger provisions of the Act, but the Panel may wish to consider the applicability of their findings to the treatment of efficiencies in the context of strategic alliances and other trade practices.

The Panel will provide a broad overview of the general economic and business context in which the efficiencies defence and other provisions of the *Competition Act* operate in Canada. In particular, the Panel should consider the arguments which link the need for Canada's approach to efficiencies in merger review, to the nature of the Canadian economy. To this end, the Panel should consider how the Canadian economy and business environment have evolved since 1986. Factors that may be taken into account include the Canada-U.S. free trade agreement (1988); NAFTA (1994); broader trade liberalization within the WTO and through other trade arrangements; changes to the levels of foreign direct investment in Canada and to levels of outward investment from Canada; changes to relative levels of business concentration and business size both domestically and internationally; productivity levels; technology and innovation; the institutionalization and internationalization of corporate ownership and any other matters that the Panel may consider relevant.

As the economy has evolved differently in different sectors, it may be necessary for the Panel to consider whether these differences are relevant for the consideration of efficiencies under the Act. In this context, the Panel will also consider the relevance of the different types of efficiencies in Canadian competition policy and, in particular, the relevance of dynamic efficiencies.

In carrying out its mandate the Panel will:

- Review the consultation paper.
- Review the report of the international roundtable held in October 2004.
- Review the written submissions provided as part of the consultation process.
- Review the report of the roundtable discussions held in Vancouver, Toronto and Montreal.
- Interview interested stakeholder groups and experts it deems appropriate.
- Review any other matters it considers salient to fulfil its mandate.

The Panel will provide the Commissioner of Competition with a written report in June 2005.

The Panel met throughout the winter and spring of 2005 and delivered its final report to the Commissioner of Competition in August 2005.

Background

The *Competition Act* became law in 1986, following almost two decades of academic and policy debate about competition law reform, including the issue of efficiencies. The Economic Council of Canada effectively launched this debate in 1969 with the release of a report that noted that small market size often resulted in Canadian firms being inadequately specialized and having short production runs that were too small to be efficient (Canada 1969). The Economic Council observed that foreign and domestic tariff protection contributed to this inefficiency, although it noted that other factors, such as transportation costs, and non-tariff barriers, such as patents and customs valuations, might have a more powerful impact on market size than tariffs in some sectors (Canada 1969, 74). The Economic Council therefore recommended that Canada adopt competition law and policy that promoted economic efficiency (Canada 1969, 19). Chapter 2 of this report discusses the Economic Council's recommendations in detail.

In the years following the release of the Economic Council's report, successive governments introduced several bills in Parliament to amend the competition law. The current efficiency defence became part of Canada's competition law when Bill C-91 was enacted as the *Competition Act* in 1986. Under section 96 of the Act the Competition Tribunal may not make an order prohibiting a merger when the merger has brought about or is likely to bring about gains in efficiency. These gains must be those that "will be greater than, and will offset, the effects of any prevention or lessening of competition" resulting from a merger.

Since 1986, the Competition Tribunal has considered the efficiency defence in two cases, but has only allowed one anti-competitive merger to proceed based on the defence. This was the merger of Superior Propane and ICG Propane. In this case, the Tribunal found in its initial decision and again after an appeal that the merger would have several anti-competitive effects, but would also result in efficiency gains that were greater than and offset those effects. (See Chapter 2 for more information on this case.) As a result, the Tribunal rejected the Commissioner of Competition's challenge to the merger on the basis that the efficiency defence applied.

Following the Superior Propane case, Bill C-249, a private member's bill that would have repealed the efficiency defence in section 96, was introduced in the House of Commons. In its place, efficiency gains would have become one of a number of factors to be considered in the

analysis of whether a merger substantially lessened or prevented competition. This approach is commonly used abroad, particularly in the United States and the European Union. Bill C-249 also proposed a "consumer benefit" requirement, in which the only efficiency gains to count would be those providing benefits to consumers, including competitive prices and increased product choice. The House of Commons passed Bill C-249, but it did not get through the Senate before the 2004 election.

Some opponents of Bill C-249 argued that it did not recognize the unique nature of the Canadian economy, referring to the smaller size, greater geographical diversity, and greater openness and world-trade orientation of the Canadian economy as compared to, for example, the American economy. These opponents argued that these characteristics amounted to reasons to retain section 96 as a uniquely Canadian approach to efficiency in merger review.

Some commentators made similar arguments during the Bureau's recent consultations. By contrast, other participants argued that repealing section 96 and having efficiency gains become one item in a list of factors to assess would be more consistent with Canadian economic conditions than is the efficiency defence. This is because this approach would allow efficiency gains to be more routinely considered in merger cases. These participants emphasized that the Superior Propane case is the only case since 1986 in which the efficiency defence has been applied.

How the Panel addressed its mandate

The Panel addressed its mandate by breaking it down into three questions.

1. What was the Economic Council of Canada's rationale for recommending in 1969 that efficiencies be given specific consideration as an "offsetting public benefit" (Canada 1969, 116) in merger review and how were these recommendations reflected in the 1986 *Competition Act*?
2. To what extent is specific consideration of efficiencies still warranted today, given the changes to the Canadian economy that have occurred since 1969 and good public policy practices?
3. If specific consideration of efficiencies is still warranted, what should be the characteristics of the treatment of efficiencies in the *Competition Act*?

The Panel's mandate required it to assess the arguments linking the efficiency defence to the state of the Canadian economy, in particular changes to the Canadian economy since 1986. However, as discussed in Chapter 2, Canada's efficiency defence was adopted based on the 1969 recommendations of the Economic Council of Canada. In 1986, Parliament neither revisited nor questioned these recommendations in light of economic changes that had occurred in the intervening 17 years. Accordingly, the Panel has focused its economic analysis on changes to the economy that have occurred since 1969.

When drafting this report, the Panel was mindful that its mandate only required it to comment on the general characteristics of the treatment of efficiencies in competition policy. The Panel examined these characteristics from an economic perspective, not from a legal or technical, drafting perspective.

The Panel's report focuses on the treatment of efficiencies in the merger context. In Appendix A, the Panel has also provided comments on the treatment of efficiencies in competition law as it applies to strategic alliances, which, as with mergers, are a form of business combination. The Panel decided not to comment on other trade practices that may be reviewed under the *Competition Act* (e.g. abuse of dominant position, refusal to deal, tied selling and exclusive dealing), since each involves unique economic considerations and none are analogous or similar to mergers.

Finally, the Panel is aware that its report is just one facet of the broad consultations. As a result, Panel members tried to avoid duplicating the input of other stakeholders.

Key concepts

The Panel relied on the following definitions of key efficiency concepts.

Allocative efficiency is a measure of the degree to which resources available to the economy are allocated to their most valuable uses. Mergers that create market power may decrease allocative efficiency by providing incentives for firms to profitably increase prices by reducing output, thereby causing consumers to limit their consumption (Canada 2004a, 41). This impedes consumption of goods and services that generate more value through consumption than through the real resource cost of supply. The loss of allocative efficiency due to a merger that results in an anti-competitive price increase is known as the **deadweight loss** (Canada 2004b, paras. 8.22–8.23).

Productive efficiency refers to the optimal use of resources, such as labour and capital, for the production of goods and services. In particular, productive efficiency is a measure of how much output is produced relative to factor inputs, such as labour, capital (plant and equipment) and technology. An increase in productive efficiency implies that more output can be produced with the same inputs. Productive efficiency is maximized when a given level of output is produced at the minimum real resource cost (Canada 2004a, 41).

Dynamic efficiency is defined in the anti-trust literature as “the effect of a merger on the introduction of new products, the development of more efficient productive processes, and the improvement of product quality and service. In particular, dynamic efficiency refers to the efficiency of the framework for decision making over time. ... Gains in dynamic efficiency may affect other categories of efficiencies,” namely allocative and productive efficiencies (Canada 2004a, 44).

Productivity is a measure of how efficiently the economy's resources are transformed into the production of goods and services. It measures how much output is produced relative to the factor inputs, namely labour, capital (plant and equipment) and technology. An increase in productivity implies that more output can be produced with the same inputs.

A related concept is **x-efficiency**, a term coined by American economist Harvey Liebenstein to characterize the organizational efficiency of firms (Liebenstein 1966). The converse concept, “x-inefficiency,” typically refers to the difference between the maximum (or theoretical) productive efficiency achievable by a firm and the actual productive efficiency attained (Canada 2004b, n. 113). The more a firm is insulated from competitive pressures, the more “fat” it may have in its organization and thus the greater its x-inefficiency.

Static efficiency comprises both allocative (demand-side) efficiency and productive (supply-side) efficiency.

About this report

The next four chapters explore these concepts, and others, as follows:

- Chapter 2 examines the historical rationale for the efficiency defence and the current treatment of efficiencies in merger review under the *Competition Act*.
- Chapter 3 looks at how the Canadian economy has changed in the last 35 years and the effect these changes have had on productivity, and examines whether the economic factors that motivated the creation of the efficiency defence still hold.
- Chapter 4 explores the link between competition and innovation.
- Chapter 5 reviews the treatment of efficiencies in merger review in other jurisdictions.

The report concludes with a series of recommendations about the characteristics of a reformed efficiencies regime (Chapter 6).

Chapter 2

Treatment of efficiencies under the *Competition Act*: History and current practice

The first half of this chapter reviews the historical rationale for Canada's merger efficiency defence, starting from the 1969 report of the Economic Council of Canada and including observations made in the 1976 Skeoch-McDonald report and by two subsequent royal commissions. The second half of the chapter sets out the general framework for merger review under the *Competition Act* and explains how efficiencies are currently treated. There follows a review of the track records of the Competition Tribunal and the Competition Bureau in taking efficiencies into account in merger cases, with particular focus on whether efficiencies have been an important consideration in merger review since 1986.

From the 1969 Economic Council report to the 1986 Competition Act

In 1966, the Government of Canada asked the Economic Council of Canada for its views on the legislative framework for consumer issues, anti-trust issues and intellectual property. In response, the Economic Council published a series of reports over the subsequent few years, each examining a specific aspect of the framework. Its July 1969 report dealt with competition policy (Canada 1969).

In 1969, tariff barriers largely sheltered Canada's domestic market from foreign competition, and free trade was an unrealistic option. The Economic Council was acutely aware of the dysfunctional impact tariffs were having on the efficiency of the Canadian economy and concluded that they tended to result in small or inadequately specialized plants operating below efficiency.

In an open economy such as Canada's, market size is affected to a considerable extent by the tariff policies adopted by both foreign and Canadian governments. Tariffs erected by other countries hamper the efforts of Canadian producers to move beyond national borders and compete for sales in world markets. Tariff barriers set by Canada shelter the domestic market from the inroads of foreign suppliers, and increase the tendency for Canadian manufacturers to try to provide a full range of the requirements of Canadian consumers. Attempts by Canadian manufacturers to supply the wide range of products desired by consumers all too often result in inadequate specialization and short production runs. There are, of course, other impediments limiting market size; in some industries, transportation costs and non-tariff barriers such as patents and the valuation placed on imports for customs purposes may have a more powerful impact (Canada 1969, 74).

The Economic Council observed that tariff barriers on many final products raised important potential obstacles to efficiency. This was because many manufacturers treated the after-tariff cost of imports as the limit up to which they could price their products, regardless of how many competitors they faced or the market share those competitors held (Canada 1969: 77). The tariff effectively sheltered manufacturers from pressure to price their products at truly competitive levels, providing them with a margin for inefficiency.

The Economic Council did not and could not have foreseen the opening up of trade that occurred in the decades following the publication of its 1969 report. That being said, the Economic Council did note the possible impact of freer trade, observing that "the reduction of tariffs on a broad front should result in some inducement for industries to move towards larger scale and increased specialization" (Canada 1969, 78). At the same time, the Economic Council stated that "the continued existence of tariff and non-tariff trade barriers for some time in the future was a reason behind the need for public policies geared toward promoting efficiency" (Canada 1969, 78).

Consistent with its observations about inefficient scale and insufficient specialization in the Canadian economy, the Economic Council advocated a single objective for competition policy: "the improvement of economic efficiency and the avoidance of economic waste" (Canada 1969, 19). It wrote, "*Competition should not itself be the objective* but rather the most important means by which efficiency is achieved" [emphasis in original] (Canada 1969, 9). The Economic Council also expressed the view that competition policy should not respond to concerns about the equitable distribution of wealth and the diffusion of economic power, since other more comprehensive and faster working instruments could more effectively do so (Canada 1969, 20). In addition, the Economic Council saw competition policy based on economic efficiency as indirectly relating to and supporting five major policy goals it had set out in a previous report — full employment, a high rate of economic growth, price stability, a viable balance of payments and an equitable distribution of wealth — but said that it did not believe that these goals should themselves be the goals of competition policy. Rather, they would be the direct or indirect by-products of a successful competition policy based on economic efficiency (Canada 1969, 21–24).

The Economic Council report included several specific recommendations aimed at improving economic efficiency through competition policy. In particular, the Economic Council recommended that specialization and export agreement provisions be added to competition law to encourage firms to join forces by agreement to increase scale and specialization.

More central to the Panel's mandate, the Economic Council made recommendations respecting the treatment of the efficiency gains a merger could generate. In particular, the Economic Council recommended that a specialized tribunal with sufficient expertise to hear and adjudicate complex economic issues deal with mergers (Canada 1969, 110). This tribunal would consider "whether the merger was likely to lessen competition to the detriment of final consumers, and whether there were likely to be any offsetting public benefits" (Canada 1969, 115–116). Among the factors the tribunal would consider was the following:

... the likelihood that the merger would be productive of substantial "social savings", i.e. savings in the use of resources (including resources used for such purposes as research and development), viewed from the standpoint of the Canadian economy as a whole (Canada 1969, 116).

The term *social savings* refers in this context to savings of the labour and capital required to produce a product and not to savings resulting from the merged firm being able, for example, to negotiate better prices from its suppliers due to increased bargaining power (Canada 1969, 117). The following example of social savings given by the Economic Council is instructive:

... an example of a cost saving to a firm that was also a social saving would be the case of a company that had grown through acquisition to the point where it was able to order its raw materials by unit trainloads and so benefit from a lower freight rate. In this instance there would be a social saving arising from the fact, of which the lower freight rate was a reflection, that moving goods in unit trainloads requires lesser total inputs of capital and labour. Thus resources would be freed and the economy as a whole would gain (Canada 1969, 117).

The Economic Council also proposed that an officer of the then Department of Consumer and Corporate Affairs be given responsibility for assessing the likely effect of mergers on competition, taking into account factors such as market share, barriers to entry and remaining competition. The Economic Council left the question of social savings to the specialized tribunal, "which in many cases would find itself required to perform a balancing assessment between possible detrimental effects on competition and possible beneficial effects in the form of social savings" (Canada 1969, 117). These two recommendations resulted several years later in the creation of the function of the Director of Investigation and Research (now the Commissioner of Competition) and the Competition Tribunal.

The Economic Council's report was the genesis of Canada's merger efficiency defence and is widely cited today as providing the theoretical rationale for retaining this defence. It is important to observe, however, that the Economic Council itself recognized that competition policy had only limited potential to improve the efficiency of the Canadian economy.

It is important to appreciate both the potentialities and the limitations of competition policy. How much it can accomplish in the way of improving economic efficiency is heavily conditioned by the setting of other economic policies and other aspects of the general economic environment. In Canada, the intensity of import competition in domestic markets is crucial. To a considerable degree, Canadian competition policy has represented an attempt to provide a partial substitute for the greater intensity of competition that would have prevailed in the absence of tariffs (Canada 1969, 24).

Our concept of the role that can usefully be played by an effective and properly administered competition policy has laid great emphasis on efficiency. In doing this, we may have conveyed an exaggerated impression of the power of competition policy to promote efficiency. In fact, sole reliance on competition policy would not be nearly enough. Mention has been made in this Report of the great importance of other policies in promoting efficient resource use. Among such other policies are those relating to taxation, tariff, manpower, government purchasing, and the regulation of transport and other activities. In some of these policies, objectives other than efficiency may at times take a higher priority, and such objectives are by no means necessarily to be disparaged (Canada 1969, 197).

In the Panel's view, the Economic Council was attempting to correct in the only way it could — by suggesting that efficiencies become part of a "balancing assessment" of mergers — the negative effects of tariff protection on the overall efficiency of the Canadian economy. The Panel believes that abolishing the tariffs would likely have been the Economic Council's preferred option, but in 1969 this was unrealistic.

In the years that followed publication of the Economic Council's report, successive governments introduced legislative bills to amend Canada's competition law, the *Combines Investigation Act*, along the lines recommended by the Economic Council.¹ All of the bills that included provisions relating to merger review also included provisions that would have prohibited the responsible court or tribunal from blocking an anti-competitive merger when it would have generated substantial efficiency gains or resource savings for the Canadian economy.

It was 17 years before Parliament adopted a new legal framework for assessing mergers. Between 1969 and 1986, there were several other studies and reports that considered the problem of scale and specialization in the Canadian economy as well as the appropriate treatment of efficiencies in relation to mergers. The key reports are described below.

Three reports ...

Skeoch-McDonald report, 1976

The authors of this report, L. A. Skeoch and B. C. McDonald, recommended that a competition board review mergers (Skeoch and McDonald 1976). If the board considered that real-cost economies would have offset the negative effects of a merger on competition, the merger should be allowed to proceed (Skeoch and McDonald 1976, 125). The authors considered that freer trade could make an important contribution to the process of economic transformation but that tariff reduction *alone* would neither help rationalize industry nor create more efficient plants. The authors also saw that investments by multinational firms, along with other measures, were important to promoting adaptability, flexibility and long-term change (Skeoch and McDonald 1976, 35-38).

The Royal Commission on Corporate Concentration, 1978

This commission, known as the Bryce Commission, saw tariff barriers as a key source of scale inefficiency in Canada, writing in its report as follows.

There are two important sources of scale inefficiency in Canada. First, to compete with imports and to satisfy consumer demand, Canadian firms in tariff-protected oligopolies produce a full line of products. Since each plant produces a much more diverse line of products than do similar-sized plants in the United States, Canadian plants employ less specialized equipment, have a higher proportion of set-up and downtime and experience fewer of the economies of scale that arise from "learning by doing". Secondly, because of the degree of foreign ownership, the small size of firms, and high product diversity within firms, firms in Canada are unwilling or unable to undertake continuous research and development on products and processes, which is necessary to compete both at home and abroad. The cost disadvantage the low level of R&D imposes on Canadian-owned firms is often significant but hard to quantify. Many Canadian-owned firms do not manufacture products that compete directly with foreign products or products of foreign-owned subsidiaries. With low R&D, Canadian-owned firms must compete at the price sensitive end of the product line or purchase new products and

¹ Bill C-256 (1971), Bill C-42 (1977), Bill C-13 (1977), Bill C-29 (1984) and Bill C-91 (1985), which became the *Competition Act* in 1986.

processes on the imperfect and often costly market for licences. Many of these problems can be attributed to the presence of high Canadian tariff barriers, which have encouraged both scale-inefficient production and foreign ownership in many industries (Royal Commission 1978, 67).

While the Bryce Commission seemed to share many of the Economic Council's views about tariffs, it had a very different perspective on merger review. The Bryce Commission recommended that corporate mergers "should not be subject to a review process or require official approval or consent before they are completed" (Royal Commission 1978, 160). Instead, the Bryce Commission believed that competition law should focus on anti-competitive conduct and should only provide ways to deal with the harmful effects of a merger when and if these effects occurred (Royal Commission 1978, 160). The Bryce Commission expressed the view that the regime proposed in then pending amendments to the *Combines Investigation Act* was overly complex. The Bryce Commission preferred a regime such as that in place in the United States at the time. There, merger reviews focused primarily on market share, without reference to offsetting benefits such as reduced costs or increased efficiency (Royal Commission 1978, 162).

Royal Commission on the Economic Union and Development Prospects for Canada, 1985

The Macdonald Commission, as this Royal Commission was known, saw trade liberalization as key to balancing the objectives of encouraging efficiency and avoiding abuses of market power, writing in its report as follows.

Competition policy in many market economies has come to reflect the thesis that the economic benefits of efficient large-scale production will often more than offset the economic costs associated with the increase in market power that is usually inherent in the development of economies of scale. In a small economy, increases in the scale of output are certain to produce net economic benefits when they occur in sectors that are subject to open competition. It is hard to over-emphasize the central role of freer trade as a force for increased domestic competition. In Canada, the number of combines cases in which removal of trade barriers would have eliminated alleged anti-competitive activities is legion (Royal Commission 1985, 220-221).

The Macdonald Commission also suggested that the role of the Director of Investigation and Research be recast to focus less on mergers, monopolies and vertical restraints and more on the fundamental conditions that determine the state of competition in Canada, such as trade barriers and regulatory restrictions on output (Royal Commission 1985, 226).

... and their influence on the treatment of efficiencies

The Skeoch-McDonald report endorsed the notion that efficiencies should be taken into account as an offsetting benefit during merger review, but this view did not receive much of a hearing. In contrast, the much more influential Bryce and Macdonald commissions were both decidedly cool toward the idea that there should be active oversight of mergers by a competition law authority. Nevertheless, the competition law reform bills that were debated throughout the 1970s and 1980s all proposed that a framework for oversight of mergers by a competition law authority and included a similar model for the treatment of efficiencies, namely that mergers that generated sufficient efficiencies could be approved even when they substantially lessened competition.

This model, which was clearly based on the Economic Council of Canada's 1969 recommendations, was first introduced in Bill C-256 in 1971 and was picked up in each successive bill up to and including Bill C-91, which was enacted as the *Competition Act* in 1986.

The House of Commons committee that studied Bill C-91 heard testimony about the free trade initiative with the United States and the need for the Canadian economy to restructure to compete with foreign producers. Committee witnesses referred, in particular, to the Canada-U.S. productivity gap, the importance of mergers as a restructuring mechanism and the increasing foreign competition (Canada 1986). Thus, Parliament was clearly aware that changes were occurring in the Canadian economy. However, there is nothing on the public record to indicate that Parliament re-examined the Economic Council's original rationale for including an efficiency defence at this time — that is, that mergers that created sufficient "social savings" would be good for the Canadian economy, despite their anti-competitive effects.

Accordingly, despite changes in the economy, the recommendations of the Economic Council were the single most important motivator behind the adoption of the efficiency defence in section 96 of the *Competition Act*. Nonetheless, elements of the *Competition Act* as passed in 1986 were at odds with recommendations of the Economic Council regarding the treatment of efficiencies. In particular, the Economic Council had proposed a competition law with the single purpose of "the improvement of economic efficiency and the avoidance of economic waste" (Canada 1969, 19). In contrast, the *Competition Act* came into effect with a purpose clause (section 1.1) that states that the Act serves a number of purposes, as follows.

The purpose of this Act is to maintain and encourage competition in Canada in order to promote the efficiency and adaptability of the Canadian economy, in order to expand opportunities for Canadian participation in world markets while at the same time recognizing the role of foreign competition in Canada, in order to ensure that small and medium-sized enterprises have an equitable opportunity to participate in the Canadian economy and in order to provide consumers with competitive prices and product choices.

The inclusion of this "multi-purpose" clause has complicated the interpretation of the efficiency defence, as is discussed below.

The drafters of the efficiency defence in section 96 also went beyond the Economic Council's recommendations by incorporating certain industrial policy elements. In particular, the Competition Tribunal is explicitly directed, when assessing the gains in efficiency generated by a merger, to consider whether those gains will enhance exports or lead to a significant substitution of Canadian domestic products for imported products.

Treatment of efficiencies under the 1986 Competition Act

General framework for merger review

Under the *Competition Act*, the Competition Tribunal has jurisdiction to order that mergers be restructured to address competition concerns.² Section 92(1) allows the Tribunal to make such an order when it finds that the merger "prevents or lessens, or is likely to prevent or lessen, competition substantially" in a relevant market. This is the Act's anti-competitive threshold. Section 93 sets out a *non-exhaustive* list of factors that the Tribunal may consider when reviewing a merger, as follows.

In determining, for the purpose of section 92, whether or not a merger or proposed merger prevents or lessens, or is likely to prevent or lessen, competition substantially, the Tribunal may have regard to the following factors:

- (a) the extent to which foreign products or foreign competitors provide or are likely to provide effective competition to the businesses of the parties to the merger or proposed merger;
- (b) whether the business, or a part of the business, of a party to the merger or proposed merger has failed or is likely to fail;
- (c) the extent to which acceptable substitutes for products supplied by the parties to the merger or proposed merger are or are likely to be available;
- (d) any barriers to entry into a market, including
 - (i) tariff and non-tariff barriers to international trade,
 - (ii) interprovincial barriers to trade, and
 - (iii) regulatory control over entry,and any effect of the merger or proposed merger on such barriers;
- (e) the extent to which effective competition remains or would remain in a market that is or would be affected by the merger or proposed merger;
- (f) any likelihood that the merger or proposed merger will or would result in the removal of a vigorous and effective competitor;
- (g) the nature and extent of change and innovation in a relevant market; and
- (h) any other factor that is relevant to competition in a market that is or would be affected by the merger or proposed merger.

Although the *Competition Act* only refers to merger review by the Competition Tribunal, in practice the Competition Bureau is primarily responsible for examining mergers. The Bureau reviews mergers using the factors set out in section 93, and has published detailed *Merger Enforcement Guidelines* that outline its enforcement approach.

The Bureau does not oppose the vast majority of the mergers it reviews. In a few cases, the Bureau's decision not to oppose a merger is based on the parties' agreement to divest certain assets or undertake other remedies. The Commissioner may apply to the Competition Tribunal for an order blocking a merger or requiring remedies when there is no agreement about any changes to the transaction that would remedy the anti-competitive effects. Frequently, the

² A registered consent agreement has the same effect as an order of the Tribunal. Under section 105 of the *Competition Act*, the Commissioner and the merging parties may sign a consent agreement. Once signed, the consent agreement may be filed with the Tribunal for immediate registration.

existence of this power is enough to prompt the parties to propose remedies, usually divestitures, aimed at addressing the Bureau's concerns. Sometimes, parties will abandon their merger when a settlement with the Bureau appears unlikely, out of a desire to avoid protracted litigation before the Tribunal.

Merging parties sometimes insist on proceeding with their merger despite Bureau concerns. In these cases, the Commissioner of Competition is forced to apply to the Competition Tribunal for an order. In response, the parties present their own positions on the facts the Bureau relied on when reviewing the merger. In addition, the parties may raise defences, including the efficiency defence. The merging parties and the Commissioner of Competition may appeal a Competition Tribunal decision to the Federal Court of Appeal.

Role of efficiencies within this framework

Efficiencies play two roles within this framework. First and foremost, they may form a defence to a merger that is found to substantially lessen or prevent competition: such a merger may proceed when the efficiencies are greater than and offset any anti-competitive effects. The defence involves a trade-off between the reduction of competition and the gains in efficiency. Second, efficiencies may be considered in the analysis of whether a merger substantially lessens competition. Both of these roles are discussed below.

The efficiency defence

Section 96 of the *Competition Act* sets out the efficiency defence as follows.

(1) Exception where gains in efficiency – The Tribunal shall not make an order under section 92 if it finds that the merger or proposed merger in respect of which the application is made has brought about or is likely to bring about gains in efficiency that will be greater than, and will offset, the effects of any prevention or lessening of competition that will result or is likely to result from the merger or proposed merger and that the gains in efficiency would not likely be attained if the order were made.

(2) Factors to be considered – In considering whether a merger or proposed merger is likely to bring about gains in efficiency described in subsection (1), the Tribunal shall consider whether such gains will result in

- (a) a significant increase in the real value of exports; or
- (b) a significant substitution of domestic products for imported products.

(3) Restriction – For the purposes of this section, the Tribunal shall not find that a merger or proposed merger has brought about or is likely to bring about gains in efficiency by reason only of a redistribution of income between two or more persons.

The efficiency defence only comes into play when a merger is found to prevent or substantially lessen competition, or would be likely to do so. When a merger meets the requirements of section 96, it is allowed to proceed without divestitures or other remedies.

The efficiency gains must be greater than and offset the effects of any lessening or prevention of competition, but Parliament failed to dictate precisely how this trade-off is to occur. This failure was the object of some discussion in the hearings of the House of Commons committee that studied Bill C-91, which became the *Competition Act* in 1986. One witness testified as follows.

... there is an inherent and unavoidable value judgment that the tribunal must make in dealing with the proposed section 68 [now section 96]. The sad part is that Parliament has given no guidance to the tribunal as to its priorities, as to the weights to be applied to the lessening of competition and gains in efficiency (Canada 1986, 3:7).

The nature and precise mechanics of the trade-off were therefore left to the Competition Tribunal and the courts.

Efficiency considered during analysis of merger

Under section 93, the Tribunal (and at first instance the Bureau) may consider any and all relevant evidence when assessing the impact of a merger on competition. Although section 93 does not actually include efficiencies as a factor, the list is non-exhaustive, due to paragraph 93(h). This paragraph explicitly allows the Bureau and the Tribunal to consider "any other factor that is relevant to competition in a market that is or would be affected by the merger or proposed merger." As a result, there may be room for the Bureau and the Tribunal to consider efficiencies in their analysis, to the extent that they are relevant to competition in the market in question.

In addition, efficiency may be implicit in some of the listed factors. For example, analysis of a merger based on paragraph 93(g), which refers to "the nature and extent of change and innovation in a relevant market," would include assessment of dynamic efficiency considerations.

Despite this, the Competition Tribunal cast some doubt on the Bureau's jurisdiction to review efficiencies under sections 92 and 93 in its second (redetermination) decision in the Superior Propane case, as follows.

It is plainly Parliament's intent that, in merger review, efficiencies are to be considered only under section 96 and not under section 92. As a result, the consideration of efficiency gains is not to be tied into the analysis of competitive effects of the merger. Section 96 is worded accordingly by requiring that gains in efficiency be "greater than and offset" the effects of lessening or prevention of competition, rather than prevent those effects from occurring. Accordingly, "cleansing" of those effects is not required under the Act and, indeed, effects of lessening or prevention of competition may remain even when the test under section 96 is met (para. 137).

This statement was not discussed in the subsequent appeal to the Federal Court of Appeal.

The Competition Tribunal and efficiencies

Only 35 of the more than 4000 mergers the Competition Bureau has reviewed since 1986 have come before the Competition Tribunal. Of these, only a handful have been substantively litigated; the vast majority resulted in consent orders or agreements, which do not involve

consideration of defences or other issues). The first case to feature an efficiency defence was *Hillsdown* (1992) but the defence was moot, since the Tribunal found that the merger did not substantially lessen or prevent competition. The defence has also been mentioned (but not applied) in a small number of other Tribunal cases.³

To date, the Tribunal has only cleared one merger based on the efficiency defence — the Superior Propane-ICG Propane merger.

In its initial decision in this case, the Competition Tribunal made a number of findings.

- The merger of Superior Propane Inc. and ICG Propane Inc., Canada's two leading suppliers of propane gas, substantially lessened competition in 66 local markets across Canada.
- The market share of the merged company would be close to that of a monopoly — more than 95 percent — in 16 of these markets.
- The merger would likely result in an average price increase for retail propane of at least eight percent.
- The merger would substantially lessen competition in the market for coordination services for national account customers and substantially prevent competition in Atlantic Canada (paras. 252, 253, 261).

The Tribunal nonetheless rejected the Commissioner's post-closing challenge to the merger, basing its decision on the efficiency defence. The Tribunal weighed the efficiency gains against the loss of allocative efficiency (or deadweight loss) — that is, the loss of resources to the economy as a whole — and found that these gains were greater than and offset the negative effects of the merger on competition. The Commissioner appealed the decision to the Federal Court of Appeal.

On appeal, the key issue was the nature of the trade-off between efficiencies and anti-competitive effects. The Court found that the Tribunal had made a legal error when it used what is known as the total surplus standard to assess the effects of the merger (paras. 73 ff). Using this standard, the Tribunal only considered the loss of allocative efficiency (or deadweight loss), not the amount of wealth likely to be transferred from consumers to producers when the merged firm raised prices. The Court rejected this approach (paras. 73, 90) and found that the Tribunal must consider *all* the anti-competitive effects of a merger, including all or part of the wealth transfer, in light of the *Competition Act*'s purpose clause (section 1.1), commenting as follows.

In spite of the existence of the multiple and ultimately inconsistent objectives set out in s. 1.1, in certain instances the Act clearly prefers one objective over another. Thus, s. 96 gives primacy to the statutory objective of economic efficiency, because it provides that, if efficiency gains exceed, and offset, the effects of an anti-competitive merger, the merger must be permitted to proceed,

³ In addition to the *Hillsdown* and *Superior Propane* cases, summary references to and/or summary discussion of the section 96 efficiency defence are found in the following four Tribunal cases: *Canada (Director of Investigation and Research) v. Air Canada* (the Tribunal observed that section 96 had to be interpreted in light of section 1.1); *Canada (Director of Investigation and Research) v. Imperial Oil Limited* (the Tribunal commented on the quantum of claimed efficiency gains); *Director of Investigation and Research v. Canadian Pacific Ltd.* (request for particulars relating to efficiencies); and *Commissioner of Competition v. Canadian Waste Services Holdings Inc.* (efficiency arguments rejected as speculative at the remedy stage).

even though it would otherwise be prohibited by s. 92. In this sense, the Tribunal was correct to state that s. 96 gives paramountcy to the statutory objective of economic efficiency.

However, it does not follow from this that the only effects to be weighted against efficiency gains are limited to the potential losses to the economy as a whole. Indeed, in the same Parliamentary speech referred to above the Minister indicated [reference omitted] that the question posed to the Tribunal is:

Would a particular merger result in efficiency gains which would offset *any* negative effects on competition? [emphasis added by the Court]

Thus, although s. 96 requires the approval of an anti-competitive merger where the efficiencies generated are greater than, and offset, its anti-competitive effects, the ultimate preference for the objective of efficiency in no way restricts the countervailing "effects" to dead weight loss. Instead, the word "effects", should be interpreted to include all the anti-competitive effects to which a merger found to fall within s. 92 in fact gives rise, having regard to *all* of the statutory purposes set out in s. 1.1 (paras. 90-92).

The Court said that it would "not prescribe the 'correct' standard for determining the extent of the anticompetitive effects of a merger" (para. 139). Instead, it suggested that an approach known as the balancing weights standard "met the broad requirements" of the Court's decision, although it would require considerable elaboration and refinement in particular cases (paras. 139-141).

The balancing weights standard requires the Competition Tribunal to consider as part of the trade-off of efficiencies and anti-competitive effects the consequences of the redistribution of wealth, in particular, the "socially adverse" portion of this redistribution. This must be weighed, along with other effects (including the loss of allocative efficiency or deadweight loss) against the efficiency gains. The question of what is socially adverse depends on the facts of a particular case. The relative weights to be attached to the efficiencies and the effects may also vary from case to case.

When the Tribunal considered the Superior Propane case again following the appeal, it found that the efficiency gains were greater than and offset the anti-competitive effects of the merger, this time using the balancing weights standard. In coming to this decision, the Tribunal considered evidence about the amount of the wealth transfer in relation to the income of propane consumers as well as about the essential and non-essential uses of propane. The Federal Court of Appeal dismissed the Commissioner's appeal of the Tribunal's second (redetermination) decision.

The end result of the Superior Propane case was that the efficiency defence was used to justify a merger that created a local monopoly in numerous markets and that substantially lessened and prevented competition in many others. The Panel does not think that the Economic Council had the creation of monopolies in mind when it advocated a defence in competition law based on "social savings."

Moreover, it has been argued that as a result of the precedent set in the Superior Propane case, and in particular the cumbersome methodology for weighing efficiency gains against anti-competitive effects approved by the Federal Court of Appeal, the efficiency defence may be less accessible today than it was when it was first enacted. In particular, a number of the business representatives and advisors who participated in the consultations the Competition Bureau launched in September 2004 have suggested that the balancing weights standard is complex and difficult to apply.⁴ It also appears from the report on the Bureau's international round table that the enforcement authorities in other jurisdictions consider that using the balancing weights standard results in merging parties who are making an efficiency argument being unable to predict the outcome of their transaction (Canada 2005, 17). Concerns were also raised at the round table about the political ramifications of valuing the effects of a merger on various types of customers differently (Canada 2005, 17).

The treatment of efficiencies by the Competition Bureau

The efficiency defence is generally regarded as being a matter for the Competition Tribunal. However, the Competition Bureau's *Merger Enforcement Guidelines* (both the 1991 and 2004 versions) discuss section 96 and encourage merging parties to bring their efficiencies claims to the Bureau at an early stage of the transaction. As such, it appears that the Bureau is willing to consider the strength of a possible efficiency defence when determining whether to devote resources to a merger challenge before the Competition Tribunal. Nonetheless, there are varying perceptions of the Bureau's willingness to consider efficiency claims in detail. In addition, the Bureau's practice in this regard seems to have changed over time.

The Bureau's merger review decisions are generally treated as confidential and are not routinely published; thus, it is not possible to determine with certainty whether, or the extent to which, the Bureau takes efficiencies into account (either as a defence or a factor). News releases the Bureau issued in the late 1980s refer to efficiency gains being as an important consideration in the Bureau's decision not to challenge a few mergers.⁵ However, some of the participants in the recent consultations on efficiencies expressed the view that the Bureau does not regularly review efficiencies nor do merging parties raise them (Intersol 2005, 7, 8, 9). For example, one commentator, a former senior enforcement official at the Competition Bureau, stated the following.

First, the efficiency defence has been applied only once in over 4,000 mergers reviewed since 1986. It has rarely played a role in the decisions of the Competition Bureau. Where it has carried some weight has been in cases where there were borderline competition problems and where efficiencies were

⁴ These views are summarized in Intersol Group (2005, 7, 8, 9). It is interesting to note that even some of those who support retaining the efficiency defence expressed the view that the total surplus standard for weighing efficiencies against anti-competitive effects should be reinstated, since it is a clear standard that does not concern itself with wealth distribution (Intersol Group 2005, 5).

⁵ See the following: "DIR announces decision on InterBake acquisition" (February 1, 1988, NR-88-9); "DIR accepts revised undertakings from Trailmobile" (July 11, 1988, NR-10124); "DIR announces decision on Dofasco acquisition of Algoma" (September 30, 1988, NR-10138); "DIR announces decision on Wolverine acquisition of Noranda Metal Industries" (November 2, 1988, NR-11044); "DIR decision on the acquisition of the assets of Domglas Inc. by Consumers Packaging Inc." (April 25, 1989, NR-10188); "Proposed merger of the brewing operations of Molson and Carling O'Keefe" (July 6, 1989, NR-10256).

significant. It has clearly not worked in the way the supporters of the defence intended (Goodmans 2004, 2).

The Bureau does take efficiency claims into account when assessing the motives for a merger, and efficiencies may be one of a number of factors the Bureau considers when deciding not to challenge a merger in a close case. However, it also appears that merging parties do not frequently present detailed efficiency arguments.

Indeed, there appears to be a strong disincentive for parties to vigorously present their efficiency claims to the Competition Bureau. In particular, relying on an efficiency defence may be viewed as an implicit or explicit admission that a merger substantially lessens competition. As a result, parties are only likely to make a strong efficiency defence argument when they are willing to litigate the matter before the Tribunal. The Panel's impression is that the business appetite for merger litigation is small, given the costs involved and the time-sensitive nature of many mergers. As a result, the Panel understands why efficiency defence arguments are rarely made to the Competition Bureau.

While the Panel cannot draw definitive conclusions about the Competition Bureau's treatment of efficiencies in cases that did not reach the Competition Tribunal, the sense of Panel members is that efficiencies (as either a factor or a defence) have not been a regular consideration in the Bureau's merger review decisions.

Are efficiencies implicitly considered?

As will be shown in Chapter 3, there is evidence that mergers have contributed to improvements in the efficiency of the Canadian economy in recent decades. During the same period, the Competition Bureau has allowed the vast majority of mergers to proceed without opposition.

In addition, the track records of the Competition Tribunal and Competition Bureau show that they tolerate greater post-merger market share and market concentration than do competition law agencies in some other jurisdictions, most notably the United States. Academic commentators have observed that when relatively high post-merger shares and concentration levels are tolerated, efficiency-enhancing mergers are allowed to proceed without the parties having to explicitly prove that the efficiencies would occur (Gal 2000, 520–521; Bork 1993, 221–222). Similar observations were made during the Bureau's recent consultations on efficiencies.⁶

Conclusions

From its review of the history and current treatment of efficiencies by the Competition Tribunal and Bureau, the Panel concludes that while efficiencies have not been entirely ignored — and they may be implicitly built into the market share thresholds the Bureau and Tribunal use — they

⁶ For example, the former Bureau enforcement official who observed that the efficiency defence has rarely played a role in the decisions of the Competition Bureau, also wrote:

...Canada has had a much more permissive approach to mergers than the United States. By setting a higher tolerance for domestic concentration and greater reliance on import competition, the Competition Bureau has provided scope for efficiency-enhancing mergers as a matter of practice, without the need for an explicit defence (Goodmans 2004, 2).

have not been a regular or explicit consideration in merger review either. At the same time, given the large number of mergers that have proceeded without opposition since 1986, there is no clear evidence that the Act impedes efficiency-enhancing mergers.

When Bill C-91 (which became the *Competition Act*) was debated in 1985–1986, there were concerns that the efficiency defence might turn out to be a loophole for anti-competitive mergers.⁷ History shows that these concerns were unwarranted. In fact, the efficiency defence has had very little public policy relevance. Certainly it has not lived up to the hopes and expectations of the members of the Economic Council of Canada. They saw their social savings “balancing assessment” as a means of ensuring that merger review promoted economic efficiency, which they thought should be the primary purpose of Canadian competition law. Indeed, structuring efficiencies as a defence may even have detracted from the explicit consideration of efficiencies.

The inclusion of an efficiency defence in the *Competition Act* was largely motivated by the recommendations of the Economic Council in 1969. These recommendations were tied to the state of the Canadian economy at that time. In light of the limited consideration of efficiencies in merger review, it is important also to review how the Canadian economy has evolved since those recommendations were made. This is the subject of Chapter 3.

⁷ See, for example, the issues discussed in the context of a motion by a member of the House of Commons committee on Bill C-91 to remove the efficiency defence from the bill, as recorded in Canada (1986, 11:38–42).

Chapter 3

Changes in the Canadian economy since 1969

In 1969, Canada's population stood at 22.3 million and its gross domestic product (GDP) at \$450 billion in today's dollars. In 2005, there are 50 percent more Canadians than there were 35 years ago — 32.2 million — and Canada's GDP is approximately three times more than it was then, at \$1.36 trillion.

Many forces contributed to the evolution of the Canadian economy, forces that were indeed active in all advanced economies. The most important ones were globalization and technological progress and, in particular, the explosion in the use of information and communications technology, which has significantly changed how business is done. Also significant was the changing role of government and government policies, such as economic regulations and trade policy. Moreover, services steadily increased their importance in the economy.

The Economic Council of Canada's 1969 conclusions about competition policy and efficiencies were based on the conditions that prevailed at that time. This chapter examines to what extent these conditions have changed and whether specific consideration of efficiencies is still warranted in competition policy.

Trade liberalization and Canadian manufacturing

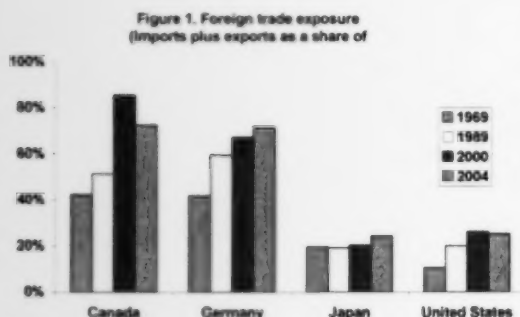
In 1969, Canada accounted for about 1.9 percent of world GDP and 0.6 percent of world population. The Canadian economy was relatively small (Maddison 2003) and protected by high tariffs, 15 percent on average (Canada 1969: 74–79). Although the economy was fairly open, free trade with the United States was not on the political horizon.⁸ The so-called National Policy, which featured significant government intervention and an array of trade barriers, guided federal economic policy. It was in these circumstances that the Economic Council promoted the idea of incorporating efficiency considerations into the competition framework: "The continuation of substantial tariff and non-tariff barriers for some time into the future is another reason behind the need for public policies geared to promote efficiency" (Canada 1969: 78).

But significant changes in the global trade environment were about to occur. Tariff barriers started coming down significantly around the world, first under the General Agreement on Tariffs and Trade and then under the World Trade Organization. In Canada, the Macdonald Commission (1985) came out in favour of free trade with the United States. Two years later, negotiations for a free trade agreement began.

The Canada–U.S. Free Trade Agreement was implemented in 1989. In 1994, it was extended to include Mexico and became the North American Free Trade Agreement (NAFTA). These two agreements dramatically opened the Canadian economy, eliminating all tariffs between the three countries and establishing non-discriminatory policies.

⁸ Two brothers, Paul Wonnacott and Ronald J. Wonnacott, the latter teaching at the University of Western Ontario, were the best known of the few promoters of the idea among academic economists in the late 1960s (see Wonnacott and Wonnacott, 1967).

As a result of global trade liberalization, Canada's exports increased dramatically. Figure 1 illustrates Canada's trade exposure (imports plus exports, as a share of GDP), which doubled in the three decades that followed the Economic Council's report. The largest increase occurred in the aftermath of the free trade agreements, between 1989 and 2000, when trade exposure peaked at 85 percent of GDP. The growth in Canada's trade exposure was significantly larger than that of any other country in the Organisation for Economic Co-operation and Development (OECD), and Figure 1 presents the situation of three of them, namely Germany, Japan and the United States.

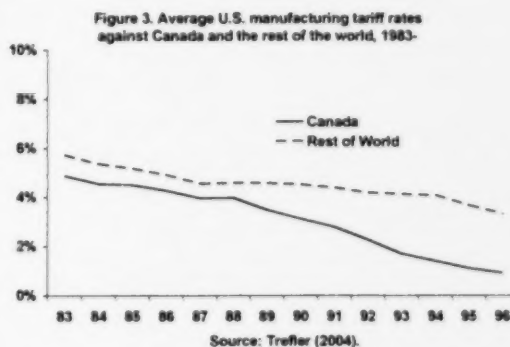
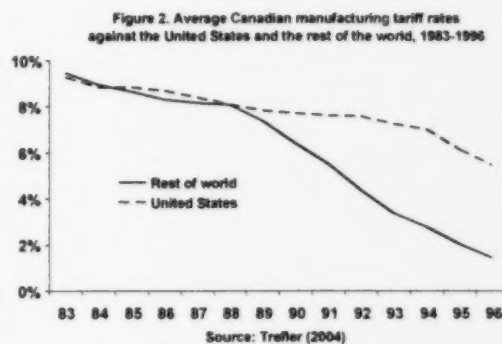


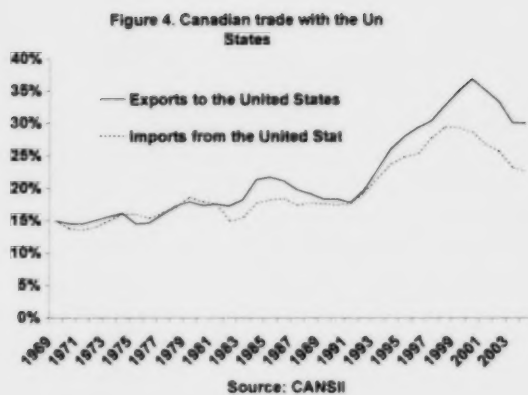
Source: OECD Economic Outlook Database.

The impact of the Canada-U.S. Free Trade Agreement and NAFTA on Canada and the U.S. was far from symmetrical. Canada's trade was much more exposed to U.S. trade and tariff reduction than the other way around. The U.S. and Mexico accounted for about 78 percent of Canadian foreign trade in 2001, whereas Canada and Mexico only accounted for about 27 percent of U.S. foreign trade. As a result, Canada's export sector was the object of much more trade pressure than its U.S. counterpart.

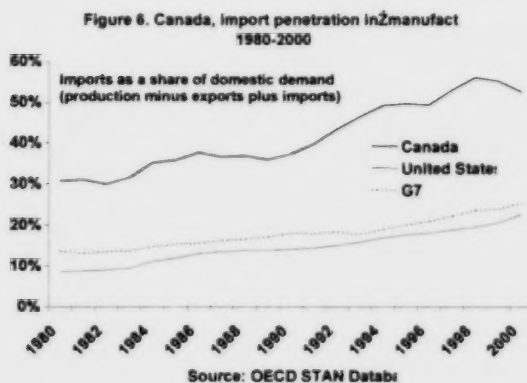
The net effect was to greatly reinforce the already significant level of integration of Canadian manufacturing with that of the United States, as shown in Figure 4. Canadian exports to the U.S. amounted to 15 percent of Canadian GDP in 1969, 18 percent in 1989 and 30 percent in 2004. Imports from the U.S. amounted to 15 percent of Canadian GDP in 1969, 18 percent in 1989 and 23 percent in 2004. Since 2000, Canada's trade exposure with the U.S. (and other countries) has deteriorated under the combined impact of the post-2000 economic slowdown, 9/11, SARS and mad cow disease, all of which directly affected Canadian trade (Canada 2001-2003).

Much of Canada's pre-2000 surge was brought about by the elimination of tariffs between Canada and the United States. Figure 2 shows the evolution of the tariffs on manufactured goods in Canada from 1983 to 1996. Starting in 1989, Canada progressively eliminated its tariff with the United States, while lowering its tariff with the rest of the world at a significantly lower rate. Figure 3 shows the same pattern for the United States.



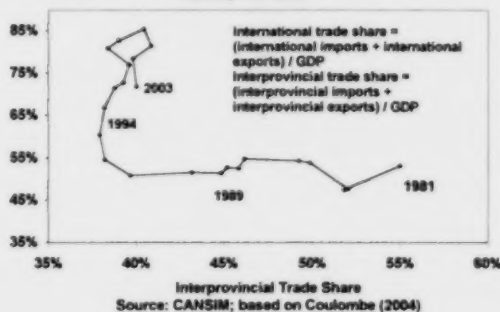


Canada now has the highest import penetration in manufacturing among G7 countries, as Figure 6 indicates (OECD 2004a). Imports as a share of domestic demand (domestic production minus exports plus imports) increased from 36 percent in 1989 to 53 percent in 2000. This led the OECD to recently conclude in its annual economic survey for Canada that “competitive pressures are strong in almost all industries and reflect the fact that the Canadian economy is extremely open to goods trade”¹⁰ (OECD 2004a, 74).



The changes free trade triggered in the Canadian economy are also evident in a graph known as the “L” curve (Figure 5). This graph maps the evolution of international trade exposure (y axis) against interprovincial trade exposure (x axis). From 1981 to 1991, as Canada debated free trade, there was little change in the international trade exposure of manufactured goods. But starting in 1991, as the effects of free trade were felt in the economy, international trade exposure increased significantly without a corresponding decline in interprovincial trade.⁹

Figure 5. International trade and interprovincial trade in Canada, 1981-2003



This has changed the Canadian manufacturing environment tremendously. In particular, it has resulted in gains in both allocative efficiency and productive efficiency in the Canadian economy (Baldwin and Caves 1997). Specifically, imports have displaced higher priced domestic products, resulting in a net gain in allocative efficiency. At the same time, the presence of foreign competition has forced inefficient producers out of business. The survivors have improved their productivity by continually adapting and renewing themselves, resulting in gains in productive efficiency.

⁹ The “L” curve also shows the impact of the other forces shaping the economy. During the 1980s, as transportation and communications costs came down, interprovincial trade exposure shrank in Canada. Direct shipments became more important and plant rationalization started, as Canadian manufacturers started to shed their protection-based business models, with a resulting lowering of interprovincial trade.

¹⁰ For discussion of competitive pressure, see Martin (2003) and Institute for Competitiveness and Prosperity (2004 a, b).

The effects of foreign competition on productivity are worth examining in more detail. The productive side of the economy, manufacturing in particular, constantly renews itself. For instance, according to Statistics Canada, the half-life of manufacturing plants in Canada is about nine years (Baldwin 2005). In other words, every nine years, half of the manufacturing plants in Canada close down. At the same time, however, new plants open up and more than make up for those that close. As a result, the stock of plants is continually renewing. For instance, a Statistics Canada survey has found that 45 percent of the manufacturing plants operating in 1999 were not operating in 1989, while 60 percent of the manufacturing plants operating in 1989 were no longer operating in 1999 (Baldwin and Gu 2005). This type of churn is normal and is found in all advanced economies but its impact is not neutral.¹¹ It is clear that manufacturing in Canada changed significantly during the 1990s, under the pressure brought by free trade.

In fact, the 1990s were significantly more turbulent for manufacturing firms than were the 1980s, the result of stronger North American competition brought about by free trade (Baldwin and Caves 1997). In fact, 40 percent of all manufacturing plants in existence in 1997 were new plants that had started operations since 1988, designed under the reality of free trade and unprotected by tariffs from U.S. competition. Moreover, 47 percent of the manufacturing plants operating in 1988 had been shut down by 1997 (Baldwin and Gu 2003a). This suggests that at least 80 percent of the plants in operation in 1990, which were set up in a protected environment, are now most likely closed.

The plants that remained open were more likely to be productive. Research indicates that a large proportion of the productivity gains observed in the aftermath of the two free trade agreements accrued from the exit of low-productivity manufacturing firms (Gu, Sawchuck and Whewall 2003). Indeed, economist Daniel Trefler found that in the industries most affected by the increased flow of imports into the Canadian market, labour productivity rose by 15 percent, with up to half of this productivity gain coming from the exit or contraction of low-productivity plants (Trefler 2004).

The impact of free trade was likely more pronounced for small manufacturing firms, which could be associated with their lower productivity (Gu, Sawchuck and Whewall 2003).

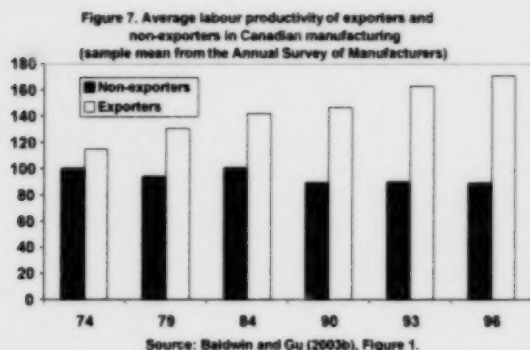
Large firms also became *more* productive in the changed environment. For instance, Baldwin and Gu (2003a) found that multi-plant firms accounted for more than 90 percent of labour productivity growth in manufacturing in Canada between 1979 and 1997. In 1997, in Canada, multi-plant firms produced 75 percent of the output and employed 60 percent of the workers in manufacturing, although they accounted for only 22 percent of all plants. Thus, while single-plant firms account for about 40 percent of employment and 78 percent of all plants in manufacturing, it is the larger multi-plant firms that have been driving productivity growth in Canadian manufacturing.

Productivity gains were also associated with gains in market share. Firms with high productivity and with high productivity growth gained market share (Baldwin and Gu 2005). Moreover, firms that used advanced technology also increased productivity and thus market share (Baldwin and

¹¹ See Caves (1998) for a review of the research on business dynamics. See Baldwin, Dunne and Haltiwanger (1998) for the comparison between Canada and U.S. data and in the evolution over time of business dynamics.

Sabourin 2004). It should be noted, however, that part of the productivity gain was due to increased competitive pressure and some was due to firms getting larger.

Figure 7, which compares the productivity of exporting and non-exporting manufacturing firms, shows that pressure to change has been higher for firms that export and thus face international competition, compared to firms that sell only in Canada. The labour productivity of manufacturing exporters has increased much more than that of non-exporters (Baldwin and Gu 2003b). In 1974, manufacturing exporters were 15 percent more productive than non-exporters; by 1996 the productivity of exporters was 92 percent greater than that of non-exporters.



Ultimately, one of the primary consequences of the increasing openness of the Canadian economy has been increased pressure on manufacturers to specialize in areas in which they can effectively compete internationally, requiring them to reduce the number of products they offer. This is shown in Figure 8, which tracks the average number of products manufactured by plants. A significant change is noticeable starting around 1990, in the aftermath of the first free trade agreement, when there was less diversification among manufacturing plants.

In fact, following the passage of the Canada–U.S. Free Trade Agreement in 1989, Canadian plants produced fewer products, and a decreasing proportion of plants manufactured multiple products, the average falling by 26 percent between 1989 and 1997. Further, as Figure 9 shows, the number of multi-product manufacturing plants fell as a share of all manufacturing plants from 65 percent to 51 percent between 1989 and 1997 (Baldwin, Beckstead and Caves 2001; Baldwin, Caves and Gu 2005). The research also indicates that plants that increased their export orientation also tended to increase product specialization.



Liberalized trade also supported specialization and efficiency by giving Canadian firms greater access to foreign inputs. The use of imports as inputs into Canadian exports rose during the 1990s, reaching a national average of 33 percent in 1999 (Ghanem and Cross 2003). The use of imports as inputs is most prevalent in manufacturing, especially in the automotive, machinery and electronic products industries.

Successful manufacturers adapted to the forces that shaped their environment. A 1998 Bank of Canada survey of 140 companies across the economy found that more than 87 percent of them



had undertaken a major restructuring in the 1990s (Kwan 2000). For 46 percent of those that restructured, they did so for reasons related to the availability of technology, an indication of the impact of information and communications technology. Other major reasons for restructuring were greater competition from Canadian firms (45 percent), greater competition from U.S. firms (31 percent) and the affordability of new technology (30 percent).¹² Baldwin and Sabourin (2004) found that manufacturing firms that invested in new technology had higher productivity growth and gained market share.

Table 1 below presents the resulting impact of these changes on labour productivity, comparing the pre-free trade period (1979 to 1989) to the post-free trade period (1989 to 1999).

Table 1
Components of labour productivity growth,
Canadian manufacturing firms

	1979–1989	1989–1999
<i>Annualized labour productivity growth</i>	<i>1.3%</i>	<i>3.2%</i>
Components of growth		
Market share gains by growing firms	48.2%	39.8%
Growth in productivity by growing firms	23.8%	21.5%
Mergers and acquisitions	19.2%	24.3%
Growth in productivity by declining firms	4.0%	9.7%
New plants and plant closures	4.8%	4.6%

Source: Adapted from Baldwin and Gu (2005: Table 7)

As the table indicates, productivity grew by 3.2 percent each year during the post-free trade decade, as compared to 1.3 percent during the previous one, a significant increase. The major source of productivity growth in both periods was successful firms that managed to grow. Their contribution to the growth in productivity came from both their gains in market share and the growth in their own labour productivity. Although their market share decreased slightly during the second decade, their gains in productivity were significantly larger.

The second source of growth in productivity was mergers and acquisitions and the resulting rationalization that followed. These contributed about one quarter of the gains in labour productivity from 1989 to 1999 period. Firms that engaged in mergers and acquisitions achieved productivity growth through various means, including economies of scale and technology transfer, and by closing inefficient plants.

The third source of productivity growth was the growth in productivity in declining firms. Although these firms lost market share, they still increased their own productivity. That increase was six times greater in the second decade, under post-free trade conditions, than in the first, as even these declining firms faced increased North American competition and fought to survive.

The last component of productivity growth was the exit of low-productivity plants and the arrival of high-productivity plants, both of which increased average productivity.

¹² Other mentions included desiring to compete globally, government regulation, greater competition from outside of North America, NAFTA, changes in the exchange rate, and the relative lack of flexibility of Canadian workers compared to U.S. workers.

The opening of markets for goods and the surge of imports in the post-free trade era forced Canadian manufacturers to adapt to new competitive conditions. The impact on productivity was significant, as Canadian manufacturing firms had to become significantly more efficient to survive.

Despite significantly freer trade, not all barriers to trade have been eliminated in the goods sector. Quotas still exist in some agricultural industries (e.g. dairy and poultry). Tariffs against manufactured goods from countries other than the United States and Mexico remain.¹³ Moreover, the cross-border movement of goods is still subject to an array of regulatory requirements (Canada 2004c, 18). On the whole, though, manufacturing is probably more open in Canada than it is in any other country of similar size.

Productivity in the Canadian services sector

Services were much less affected by the two free trade agreements, because they are not traded to the same extent as are goods. On the whole, the services sector has grown at a faster pace than has manufacturing: from 50 percent of GDP in 1969 to 67 percent in 2001. In 1969, manufacturing was the biggest component of the economy, accounting for 22 percent of GDP, followed by financial services (more specifically, finance, insurance, real estate and rental and leasing services) at 14 percent. Today, these two have switched places. In 2001, financial services accounted for 19 percent of GDP while manufacturing represented only 17 percent.¹⁴

The growth of the services sector is also reflected in employment data. In 1976, the services sector accounted for 65 percent of total employment. By 2004, that figure had climbed to 75 percent. Manufacturing employment decreased from 19 percent of total employment to 14 percent. Health care and social services, in contrast, grew from 8 percent to 11 percent of total employment.

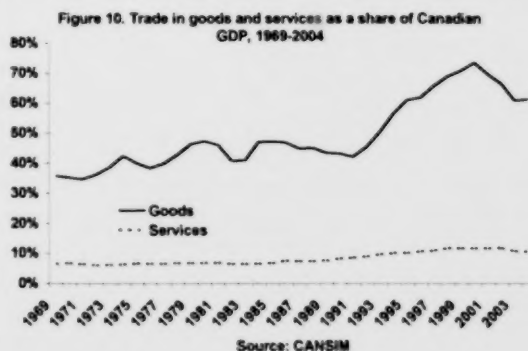
Paradoxically, the increasing share of employment represented by the production of services was brought about partly by the significant productivity advances in goods production, especially manufacturing (Baldwin, Durand and Hosein 2001). Fewer resources are required to produce goods as productivity increases. As a result, the reduction in the real prices of goods over time has more than offset the increase in volume produced, which has led to the shrinking of the relative size in the economy of the goods-producing sector and of manufacturing in particular (Baldwin, Durand and Hosein 2001). Rising incomes and lower real prices for goods have left consumers with more income with which to purchase services, which has contributed to the growth in the GDP share of the services sector. In addition, service industries have grown as manufacturers outsource their non-core functions to specialists.

¹³ For example, tariffs on textile products from countries other than the United States average 9.6 percent; this figure is 14.1 percent for clothing products. Wyman (2005).

¹⁴ The Statistics Canada time series for GDP by industry in current dollars is currently only updated to 2001. However, the most up-to-date constant dollar series has data up to 2004, but only goes back to 1981 because of changes to industry classifications and measurement. For this particular comparison, the current dollar series was selected so that a single consistent time series could be used. For information purposes, in 2004 (constant 1997 dollars, basic prices), the goods-producing sector share was 31 percent, services-producing sector 69 percent, with manufacturing at 17 percent and finance, insurance, real estate and rental and leasing services (and management of companies and enterprises) at 20 percent.

As Figure 10 shows, services remain a small component of international trade, accounting for less than 15 percent of Canada's trade. This is because services are intangible and thus less transportable than goods. Most services, such as retail and personal services, are delivered locally, with production and consumption occurring simultaneously in many cases, such as in the case of a haircut. Further, the delivery of many services depends on the individual service provider. A hairdresser, for example, cannot export his or her services, short of travelling.

International trade in services is also hampered by the existence of numerous non-tariff barriers and regulations that impede competition in and entry into the services sector. A case in point is restrictions on foreign direct investment. A recent survey found that Canada has the second highest level of restrictions on foreign direct investment in the OECD (Baldwin and Sabourin 2004). These restrictions primarily affect service activities, curtailing foreign entry into industries that the government deems strategic, including broadcasting and telecommunications (2.8 percent of GDP), banking (3.2 percent) and air transport (0.4 percent). The government justifies foreign ownership restrictions in media and book distribution by citing the need to develop and protect national identity.



All together, industries in which foreign entry is constrained represent a small but significant portion — about 6.4 percent — of the economy, as Table 2 indicates.

Other areas of the service economy are subject to significant government ownership (e.g. electric utilities, the postal service) or restrictions associated with their public financing (e.g. health care, education). Competition in these areas is usually absent or heavily regulated, effectively pushing them outside the market economy. These public and para-public services represent more than 16 percent of the economy and include public administration (5.5 percent), health care and social assistance (5.9 percent) and public and post-secondary education (4.3 percent).

Table 2 The importance of the constrained ¹⁵ services, as a percentage of real GDP, 2004	
Sectors	% of GDP
Goods	33
Services	67
Unconstrained	44.3
• Retail, wholesale, insurance, business services, etc.	
Constrained	
• Banking	3.2
• Telecommunications, media, book selling	2.8
• Air transport	0.4
Total, constrained services	6.4
Public, para-public	16.3

The Canadian services sector has evolved significantly since the late 1960s but it has been not been subjected to the same forces of change as was the Canadian manufacturing sector, in particular, the opening up of the Canada-U.S. border. Moreover, a significant share of the service economy is shielded either from competition by being in the public or para-public sector, or shielded from foreign competition because of public policy decisions. Thus, one would not

¹⁵ The word *constrained* refers to foreign entry into this sector. Public services include public administration at all levels. Para-public services include health care and social assistance, postal service and urban transit.

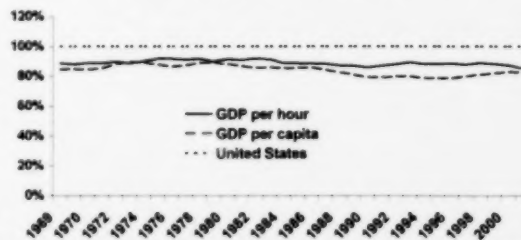
expect productivity to have evolved in the services sector in the same fashion as in the manufacturing sector. Indeed, John Baldwin of Statistics Canada estimates that Canada's productivity in the services sector is about three quarters of U.S. services sector productivity, whereas the gap is much narrower in the manufacturing sector, because of its openness to the U.S. economy.¹⁶

Canada's productivity challenge

One of the puzzles of the Canadian economy is why, despite the massive opening of its economy to North American integration, its productivity remains significantly below that of the United States and, indeed, has been slipping relative to that of other countries.

Figure 11 shows two measures of the Canadian productivity gap with the U.S. One measure is GDP per capita and the other is labour productivity, or real output per hour worked, both expressed as a percentage of the U.S. figures. Relative output per capita increased in the 1970s and then fell until the mid-1990s. (There has been a small rebound since then.) Labour productivity measured in terms of hours worked fell steadily throughout the period.

Figure 11. Canadian labour productivity and GDP per capita (% of United States)



Source: Groningen Growth and Development Centre and The Conference Board, Total Economy Database, January 2006, www.ggdic.net

Canada has also fared badly in comparison with other OECD countries, as Table 3 indicates. On labour productivity specifically, Canada fell from the fourth rank in 1969 to the sixteenth in 2004. Canadian output per hour worked is now at 79 percent that of the United States, significantly lower for instance than that of Ireland and France and lower than that of the U.K., Sweden and Australia, as shown in Table 3. In 1969, Canada's labour productivity was higher than that of all these countries.

Table 3
Productivity ranking, selected OECD countries (out of a list of 21)

	GDP per capita 2004 (% of U.S.)	GDP per hour worked % of U.S.		% growth 1999–2004	GDP per capita 2004	Rank (out of 21)		
		1969	2004			1969	2004	Growth 1999–2004 (rank)
U.S.	100			5.79	1	2	6	4
Ireland	91	44	108	9.25	3	18	4	1
Canada	79	88	79	2.79	6	4	16	14
U.K.	78	67	89	4.16	8	14	11	7
Sweden	77	80	88	4.81	10	6	13	6
France	75	78	116	5.16	16	7	2	5
Australia	77	79	81	2.88	7	10	15	13

Source: www.ggdic.net

Moreover, the data from 1999 to 2004, also presented in Table 3, suggest that Canada is not catching up, despite NAFTA. On labour productivity growth, Canada ranks 14th out of 21 OECD countries for the period from 1999 to 2001.

¹⁶ Direct communications with the Panel, to be published in a forthcoming study of productivity in the Canadian services sector.

Countless papers have been produced to explain Canada's sluggish productivity performance, since 2000 in particular. Andrew Sharpe, Executive Director of the Centre for the Study of Living Standards, and one of the recognized specialists on the issue, recently reviewed the literature on Canada's productivity performance and identified several factors that explain the productivity gap (Sharpe 2003).¹⁷

Sharpe identified what he deems the five most important factors that explain the productivity gap:

- the lower capital intensity of economic activity in Canada;
- Canada's innovation gap, which is reflected in lower research and development expenditures and less patent activity than in the U.S. and in slower adaptation of best practices techniques (see Chapter 4 for more on this);
- Canada's smaller high tech and, in particular, information and communications technology industries, compared to those in the U.S., which drove recent productivity growth;
- a lack of human capital at the top end of the economy, as seen in the proportionally fewer university graduates and scientists and engineers in research and development activities in Canada; and
- the smaller scale of manufacturing plants.

Factors that Sharpe ruled out are industry structures, human capital other than at the top end of the economy, taxes, social policies, unionization, labour market policies and product market regulations.

Sharpe relied on research conducted by Statistics Canada in recent years on the micro-economic structure of the Canadian goods-producing sector. That research suggests a connection between the size of Canadian manufacturing plants and the productivity gap.¹⁸ In particular, Baldwin, Jarmin and Tang (2004) found that from 1972 to 1997 Canada had fewer large manufacturing plants (500+ employees) than did the United States, as a share of both manufacturing employment and output. The research indicates that despite NAFTA, Canada has smaller manufacturing plants and that these plants are not only generally less productive than larger ones but they are also not improving their productivity as much as the large plants are. Thus, the smaller scale of manufacturing plants is likely contributing to lower Canadian productivity, despite the openness of the Canadian manufacturing sector.

However, the differences in productivity between Canada and U.S. manufacturing should not be overstated. Recent research by Baldwin suggests that, within the normal margin of uncertainty of such measures, productivity in Canadian manufacturing could be more or less at par with that of

¹⁷ The *International Productivity Monitor*, a well-respected quarterly journal published by the Centre for the Study of Living Standards, an Ottawa think tank, is the main venue for debating productivity in Canada.

¹⁸ As in most countries, services are also regulated through qualifications, from those for professionals such as lawyers and accountants to those for people who work in skilled trades, such as electricians and plumbers. As a result of this controlled access, supply is restricted in these mostly domestic (e.g. non-traded) areas. Prices end up being higher and the businesses do not operate at their optimal efficiency. Consumer protection is the justification government uses for such controlled access, resulting in an implicit trade-off between regulated quality of services and their broader availability and lower prices.

the United States. In other words, the impact of the smaller Canadian plants with their lower productivity may not be very large, given that the large plants contribute most of the output.

The same conditions contributing to the smaller size of Canadian manufacturing plants are also likely at play in the services sector, and they could contribute significantly to Canada's lower productivity. According to Baldwin, the major differences between Canada and the U.S. are in the services sector, in which the productivity gap could be as high as 25 percent. The less dense urban geography of Canada and, in particular, the smaller cities, could result in smaller and thus less productive local service firms. Constraints on foreign investment in strategic industries, more zoning regulations directed at large retail operations, and smaller capital intensity could also hamper services sector productivity, since they result in smaller local service facilities.¹⁹

The impact of borders

One of the major assumptions behind the efforts to remove trade barriers such as tariffs was that they constituted an overwhelming influence on cross-border trade. Removing these barriers, it was assumed, would increase competition from imports, putting sufficient competitive pressure on domestic firms such that productivity would increase.

The persistence of the productivity gap has led economists to consider the role played by the so-called border effect in shielding domestic producers from international competition. Research initiated in the late 1980s by John McCallum, when he was an economics professor at McGill University, first pointed out that national borders mattered much more to commercial exchanges than was commonly assumed at the time, even in the absence of tariffs (McCallum 1995). His research showed that in the absence of tariffs, the Canada-U.S. border was 10 times as much of an obstacle to trade as the actual cost of transportation suggested. (In the so-called gravity model used by economists to explain trade patterns, this difference was equivalent to multiplying by 10 the distance from a plant to a market whenever there is border crossing.)

John Helliwell extended that research for all countries. In a series of papers published throughout the 1990s, he not only confirmed McCallum's basic finding but also fully documented its effect, which pervades the economic structures of most countries, and of small countries in particular. (Helliwell 1998). In fact, Helliwell's work shattered many of the assumptions behind the "open economy" models that economists and policy makers were using. He demonstrated that there is much more than tariff barriers associated with borders.²⁰ Different laws and regulations, different service organizations, lower capital and labour mobility and, sometimes, different languages and cultures add up to a significant barrier to the smooth flow of goods and services across a national border. As a result, transnational organizations set up separate divisions in each country, creating an additional factor that strongly influences market definitions in multi-country situations.

Thus, the removal of tariffs on manufactured goods as a result of the Canada-U.S. Free Trade Agreement and NAFTA did not eliminate all obstacles to trade between Canada, the U.S. and Mexico. The border remains, with its trade-hindering effects. In manufacturing, then, there are sound reasons for firms to set up in Canada plants designed at a less-than-optimal global scale —

¹⁹ Discussions with John Baldwin

²⁰ A paper by Brown (2003) based on 1993 data suggests that in Canada the border effect is much less important than what McCallum and Helliwell found. Brown suggests a 2X factor instead of a 10X factor but does not challenge the existence of a border effect.

that is, not at the most efficient level that would minimize resources — despite the opening up of North American borders. These smaller Canadian plants can be competitive with imports from larger, more efficient U.S. plants, since the latter have to cope with border effects, which increase the landed price of their products in Canada.

Moreover, these border effects are likely to remain. In particular, the Internet will not eliminate them, since they result not only from differences in traditional trade inhibitors, such as regulations, but also from institutionally induced differences, such as the wider use of metric system in Canada. Thus, as long as countries differ, there will be border effects that will hamper trade in manufactured goods and somewhat protect domestic producers, allowing them to survive even when they are less productive or efficient than are their foreign competitors.

Helliwell estimates that border effects are twice as large for services as they are for goods. Not only does that explain why international trade in services has not grown as quickly as trade in goods but it also suggests that productivity differences may be significantly higher in the services sector than in the goods-producing sector (Helliwell 1998, 38). Different laws and regulations that specifically affect the provision of services, and subsequent differences in the way service businesses cope with these differences, are likely to have pervasive effects on services. For instance, laws and regulations that affect urbanization patterns influence the size of local markets and thus the size of the service establishments in these markets. In the constrained sectors, public policy prevents global corporations from entering the Canadian market, which affects the average size of the entities that operate in these sectors. Protection from direct foreign competition in the airline industry affects price structures in Canada. This, in turn, has an impact on demand and thus on resources used. All these non trade-related factors may contribute to lower productivity of services in Canada.

In other words, Canadian service providers are protected from competition from their U.S. rivals by the existence of important border effects. Because the Canadian market is smaller, Canadian service firms tend to be smaller than their U.S. counterparts and do not operate at the same efficiency when economies of scale are present.

As noted above, these border effects will not disappear and their continued existence will have dysfunctional effects on productivity and thus on efficiency²¹ (Sharpe 2003, 12).

Efficiency still matters

The Canadian economy has changed dramatically since 1969. It is now a very open economy, with one of the highest trade intensities among OECD countries. The impact of this growing openness is best felt in manufacturing. Canadian manufacturers are facing more U.S. competition than ever and are pulling their weight: they are competitive. In a sense, they have to be efficient or they would go out of business. But that does not mean that they are necessarily as efficient as their U.S. counterparts, because of border effects. Although the gap is probably not large, there is still cause for concern. A recent submission by Paul Darby, chief economist of the Conference Board of Canada, to the House of Commons Standing Committee on Banking and Commerce

²¹ On the other hand, John Helliwell argues that the loss of efficiency may not be as significant as thought under standard economic interpretations. His view is that border effects allow social trust to develop within a country, and social trust can greatly increase the overall efficiency of an economy by simplifying transactions and lowering their costs. The gains in efficiency from higher social trust may offset any losses from the lower scale of the "protected" production units. See Helliwell (1998, 124).

summarized the expert consensus on the issue: barriers to trade other than tariffs still have a "very significant impact on productivity in the primary and manufacturing sectors of the Canadian economy" (Darby 2005). Thus, despite the significant opening of the Canadian economy, the Economic Council of Canada's 1969 argument may still be valid for manufacturing, implying that competition policy may still contribute to enhancing the efficiency of manufacturers.

This applies even more clearly to Canada's services sector. Services are such that they are not a large part of international trade and have not, as a result, been significantly exposed to increased North American competition as tariffs were eliminated. Moreover, because of Canada's particular pattern of urbanization, many Canadian service firms are smaller than their counterparts in the United States.

In addition, there is a large segment of the service economy that operates in a protected environment, very much like manufacturing did in the 1960s. Some of these industries are highly strategic in today's economy: banking, telecommunications and media. It is possible that their protected status artificially maintains them at less than their optimal size and thus at less than full efficiency. Without the pressure from foreign firms, they are not as productive and innovative as they could be. Finally, many Canadian service firms are government-owned or -regulated (particularly in health and education) and as a result are somewhat shielded from competition.

Thus, the Economic Council's 1969 concerns about inefficiency are still valid for services, although the sources of inefficiency are quite different from those affecting manufacturing in 1969.

Canadians should be concerned by the lower productivity of the Canadian economy. Although there is some evidence that much of the productivity gap between Canada and the U.S. can be attributed to the services sector, it is clear that the effects of freer trade were neither universal nor immediate. As time goes on, international competitive pressures may increase. In particular, cross-border competition is likely to become more prevalent in services and more non-tariff barriers are likely to be eliminated.

Still, border effects will remain and it is likely that they will always have some residual impact. Thus, the Economic Council's 1969 argument will always be valid in some regard. It is the Panel's view then that competition policy should continue to play a role in encouraging more efficiency in the Canadian economy.

Chapter 4

Promoting dynamic efficiency as public policy

This chapter examines the promotion of dynamic efficiency — innovation — as public policy. The first part of the chapter deals with the place of innovation on Canada's public policy agenda. The second part of the chapter looks at the relationship between competition and innovation, in particular research that relates industry concentration and innovation.

Innovation and Canada's public policy agenda

The pursuit of greater productive efficiency permeates the current economic agendas of governments across Canada. Indeed, increasing productive efficiency is the key to improving Canadians' standard of living, since it results in more value being produced from existing economic resources.

Greater efficiency is achieved by various means. Broad policies, such as fiscal and monetary policies, expanding trade, manpower training and tax policies, encourage investment and the expansion of economic activities and thus target both employment creation and productivity. Moreover, given that capital intensity is a major factor that explains Canada's lower productivity, policies encouraging investment — and in that regard, the spectrum of policies can be very broad — will tend to increase the productivity of the Canadian economy and lead to better use of labour. In fact, any policy that aims to make the economy more competitive bears on productive efficiency.

There are also policies that are specifically directed at innovation, which aim to improve productivity through the better use of existing factors. Throughout the world, governments have developed innovation agendas, driven by the recognition that ideas spur economic growth. The Organisation for Economic Co-operation and Development (OECD) regularly surveys the innovation policies of its member states and publishes a scorecard tracking countries' innovation performance.²²

In Canada, the federal and provincial governments have placed great value on innovation in recent years. Governments offer tax credits for research and development expenditures, fund commercialization strategies for university-based research and development, encourage greater participation in post-secondary education and lifelong learning, facilitate the development of clusters and encourage more collaboration between the academic and business communities.

In 2002, the federal government put forward its *Innovation Strategy* (Canada 2002a, b). The strategy calls on the public, private and non-profit sectors to collaborate to achieve the objective of "increasing Canada's innovation capacity and creating a culture of innovation and learning."²³ Each of the four pillars of the strategy — knowledge performance, skills, the innovation environment and strengthening communities — has detailed goals and targets, and action plans.

²² The OECD publishes the *OECD Science, Technology and Industry Outlook* and *OECD Science, Technology and Industry Scoreboard* are published in alternate years, along with abundant documentation on member countries' specific innovation policies.

²³ Innovation in Canada website: www.innovation.gc.ca.

Provincial governments have also implemented strategies to enhance productivity and innovative capacity. For example, in recent years successive Ontario governments have introduced a number of programs designed to enhance human capital, cluster development and greater collaboration between the business and academic communities. These programs include the Biotechnology Cluster Innovation Program, the Medical and Related Sciences Discovery District, the Ontario Commercialization Advisory Committee and the Task Force on Competitiveness, Productivity and Economic Progress.²⁴

Despite these efforts, Canada still trails other countries in research and development investment, which may partly explain Canada's recent poor productivity growth. In 1981, Canada made investments in research and development amounting to 1.2 percent of gross domestic product (GDP). This compares to 2.3 percent in the United States and the OECD average of 1.9 percent. By 2002, Canada had increased spending to 1.9 percent of GDP, narrowing the gap but still trailing the United States (2.7 percent) and the OECD average (2.3 percent) (OECD 2004b). Data also indicate that Canada trails the world leaders in other innovation-related factors such as per capita research and development expenditures and the proportion of the workforce engaged in research and development (OECD 2004b).

Innovation strategies tend to focus on the structures that support innovation, in particular building human capital and collaboration between the various sectors of society. This suggests that policy makers believe that innovation policy should focus more on support than pressure for innovation. Pressure for innovation will come from customers and rivals, which is the realm of competition policy.

Competition and innovation

Competition between firms is one factor that influences the rate of productivity-enhancing innovation in an economy. Competition creates pressure conducive to innovation, since firms that increase their productivity to surpass that of their competitors will increase market share and profits. This was illustrated, for example, in Figure 7 in Chapter 3, which showed that exporting firms had experienced larger productivity gains than had non-exporters, reflecting the stronger competitive pressures resulting from international trade.

But given that many other factors are involved in innovation, it is not surprising that international evidence about the relationship between market concentration (i.e. the number of competitors), firm size and innovation (typically measured by research and development spending) is mixed.²⁵ Studies by the OECD examining competition and innovation came up with a variety of findings with no clear pattern. Some of these findings are as follows.

- There are both negative and positive relationships between industry concentration and the level of research and development spending.
- There is a positive relationship between concentration and firm size and research and development up to a point and a negative relationship thereafter (an "inverted U" relationship; see below).

²⁴ See Ontario Ministry of Economic Development and Trade: www.ontariocanada.com; Institute for Competitiveness and Prosperity: www.competeprosper.ca.

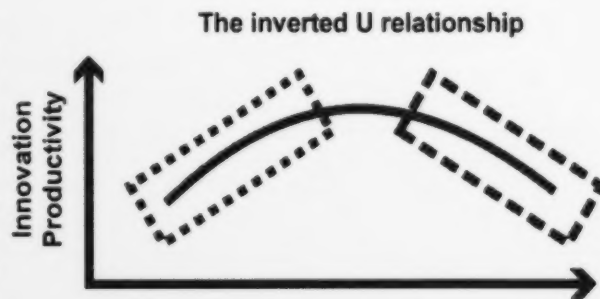
²⁵ See Ahn (2002) and Symeonidis (1996) for literature reviews.

- These relationships differ by industry. For example, there appears to be a positive relationship with large firms in concentrated and relatively capital-intensive industries and a positive relationship with smaller firms in relatively skill-intensive industries (Ahn 2002).

The absence of a clear linear relationship between innovation and productivity, on the one hand, and firm size and industry concentration on the other suggests an inverted-U shaped pattern. Thus, within the same industry, both a positive relationship and a negative relationship could hold, depending on how big a firm is or on how much concentration there is. In other words, there is an optimal size at which productivity is at a maximum. Firms falling on either side of that optimal point are less productive and less capacity for innovation. The same pattern can also be applied to industry concentration, implying that both extensive fragmentation and high concentration are probably associated with both lower productivity and with less innovation. This is illustrated in Figure 1 (Aghion et al. 2003).

Figure 1

In area A, innovation and productivity are below the optimal level because the firms are too small and cannot muster the necessary resources. In area B, by contrast, the firms are too large and suffer from bureaucratic inertia. The same can be said about concentration. An industry characterized by low concentration does not have the leaders and large enough firms to stimulate innovation-based competition. On the other hand, competition in an



an overly concentrated industry (area B) is too weak to stimulate productivity and innovation.

Since firms can be on either side of the inverted U, and the shape of the curve varies between industries, it is impossible to establish a linear relationship between efficiency or innovation and either concentration or firm size. Not surprisingly, a leading authority on innovation and productivity, Dr Sanghoon Ahn, concludes that "there is little empirical support for the view that large firm size or high concentration is strongly associated with a higher level of innovative activity." He adds, "All in all, empirical evidence does not support the view that market concentration is an independent and significant determinant of innovative behavior and performance" (Ahn 2002, 16).

In Canada, Charlene Lomno at Statistics Canada has done research that suggests no relationship exists between concentration of research and development spending in an industry and total amount of research and development spent by industry (Lomno 2003). Moreover, it is very difficult to establish a pattern between industries. As one author noted, "R&D intensity and market structure are jointly determined by technology, the characteristics of demand, the institutional framework, strategic interaction and *chance*" [emphasis added] (Symeonidis 1996, 1).

Research also indicates that the number of competitors is not necessarily an accurate indication of the *intensity* of competition between firms, at least with respect to innovation. A high degree of market concentration does not imply a low level of competitive pressure in all circumstances. For example, an analysis by the Centre for the Study of Living Standards notes that "a high

market share held by a small number of firms is not necessarily inconsistent with intense competition. Concentration can improve productivity through achieving economies of scale, and it can also boost productivity if it allows a small number of large firms to compete intensely with each other" (Kellison 2004, v).

Firm size and innovation

In contrast, size matters when it comes to innovation. The belief that small firms are more innovative than large firms is a myth. Statistics Canada's Survey of Innovation and Advanced Technology suggests a positive relationship between size and innovation. In particular, the smallest manufacturing firms (fewer than 20 employees) report innovation at roughly half the rate of the largest firms (2,000+ employees) (Baldwin and Hanel 2003).

Further, an examination of the results of Statistics Canada's Survey of Electronic Commerce and Technology shows that organizational and technological improvements are positively related to firm size (measured by the number of employees) in both the goods and services sectors. This "suggests that larger firms [500+ employees] can more readily absorb the costs associated with technological change which include not only the initial lay-out for technological acquisition but also the often associated training, work interruption due to installation as well as potential short-term loss of productivity" (Earl 2004, 18).

This indicates that large Canadian firms have more support for innovation than do small firms. It should also be noted that large manufacturing firms (250+ employees) are more likely to be exporters than are smaller firms (Baldwin and Gu 2003b). As a result, larger firms face greater competitive pressures than do smaller firms, motivating larger firms to be innovative.

Interestingly, research has also shown that "overall, the services sector's inclination towards technological change mirrored that of the goods sector" (Earl 2004, 10). Given the widely held view that, in general, border effects and the characteristics of many service industries result in less competitive pressure in the services sector than in the goods-producing sector, this research suggests that factors other than competition play a significant role in innovation.²⁶

These findings underscore the fact that innovation occurs within a complex set of interactions, making it difficult to isolate and evaluate the value of its specific elements. As a result, "In many market circumstances there is so much serendipity in research and development that it is impossible to predict the sources of innovation with reasonable certainty" (Gilbert and Sunshine 1995, 588). Moreover, developing and adopting new products and technology does not necessarily imply commercial success. As Baldwin and Sabourin have stated, "Plants may adopt new technologies in order to improve relative productivity and gain market share. But the growth process is on the whole stochastic, depending not only on production success but also on the whims of consumer demand" (Baldwin and Sabourin 2004, 29).

²⁶ The data on innovation are far from ideal. Innovations that are primarily non-technological and/or related to non-tangible goods are difficult to identify and measure, especially in service industries in which human capital is essential and output is not easily defined (Hanel 2004). Further, with respect to services, Hanel (2004, 28) states that "the information on innovation activities in the service industries is, so far, less complete and less reliable than information on innovation in manufacturing industries" (Hanel 2004, 28).

Conclusions

Innovation, or as it is sometimes called in the merger literature, dynamic efficiency, is the result of numerous factors interacting and contributing to a more valuable output out of the combination of existing production factors. Government policies, such as the federal *Innovation Strategy*, focus mainly on increasing support for innovation through enhancing human capital development. But innovation is a complicated process, and firms require both market pressure and support to be innovative. In certain industries it may be that an increase in competitive pressure, alongside increases in support for innovation, is what is needed to create the environment most conducive to innovation and, as a result, higher productivity.

However, while competitive pressure is important to a successful economy, infrastructure, education, attitudes and many other variables also play an important role. Overall, the mixed results of economic research on competition, firm size and productivity-enhancing investments in innovation, and on the difficulties of successfully implementing new technologies, suggest that deliberately increasing competition (or, alternatively, deliberately encouraging market concentration) would not, by itself, have a predictable and replicable impact on Canada's innovative capacity. In some cases, increasing concentration in an industry may lead to more innovation and benefit the economy; in other cases, increasing concentration may have a negative effect. This suggests that a one-size-fits-all approach to enhancing dynamic efficiency through competition policy will not work. Indeed, the effect of a more or less restrictive merger policy, or a merger policy with more or less consideration given to efficiencies, will vary both in significance and in the direction of its impact from one case to another.

As a result, it is impossible to have a detailed and comprehensive roadmap to determine how and when competition policy should take innovation (dynamic efficiency) into consideration. There are no universal criteria for determining when innovation would be relevant or how much weight it should be given. Concentration (and the associated intensity of competition) is one factor among many. Size is sometimes positively correlated with innovation, sometimes negatively. The circumstances in each case will be unique. For these reasons, the effects of a merger on dynamic efficiency must be assessed case by case.

An additional complexity is the often long time horizon for realizing dynamic efficiencies. The economic impact of innovation more often than not does not materialize within the two-year time frame that is commonly used to assess the impact of mergers.²⁷ This poses more difficulties for measuring and assessing the impact of a merger on the efficiency of the economy, even in cases when this impact is deemed significant.

Innovation is a critical component of any public policy framework aimed at enhancing the efficiency and productivity of the economy. Governments strive to promote innovation through a wide array of policies. There is nothing to suggest that competition policy should be excluded in that regard. On the other hand, competition policy should not have to shoulder more than it is able.

²⁷ The 2004 version of the *Merger Enforcement Guidelines* indicates that the Competition Bureau typically uses two years as a rule of thumb in these cases (Canada 2004b, n. 19).

Chapter 5

Treatment of efficiencies in other jurisdictions

The Panel's mandate required it to review the Competition Bureau's report on the October 2004 international round table involving competition law enforcement authorities from Australia, Canada, the European Union, Mexico, the United Kingdom and the United States. The report also includes the Bureau's summary of written submissions from Germany, Japan, Norway, Sweden and South Africa (Canada 2005). In addition, the Bureau's 2004 consultation paper includes information about the treatment of efficiencies in the competition laws of Australia, the European Union, Mexico and the United States.

As a general rule, the Panel's view is that convergence of Canadian laws with those of other major jurisdictions is good public policy. However, this should not prevent Canada from adopting a unique approach when the situation demands it, since Canada has maintained and fostered its own distinctive culture, despite its profound ties with the United States.

Yet, Canada's distinctiveness should not preclude convergence. The External Advisory Committee on Smart Regulation, which tabled its report last year, took a strong stand on this issue, saying that when no specific reason justified a Canadian-specific approach to regulation, Canada should try to harmonize its approach with those of the United States and Mexico²⁸ (Canada 2004c). Daniel Schwanen, a Canadian economist who writes extensively on public policy issues, takes a similar stand in *Deeper, Broader: A Roadmap for a Treaty of North America*, his monograph on post-NAFTA arrangements. While recognizing the right and the importance of Canada to develop distinctive policies that respond to its unique needs, Schwanen says it is also important for Canada to take into account when drafting regulations the significant interdependence of the three North American countries. This is particularly the case in the area of economics; here, integration is most pronounced (Schwanen 2004).

The Panel's observations on the international round table report

At the outset, it should be noted that the Panel understands that all of the countries that sent representatives to the international round table have in place legislation that allows them to review mergers to determine whether such mergers are anti-competitive. The test for determining whether a merger is anti-competitive varies from jurisdiction to jurisdiction, with some jurisdictions (including Canada, as discussed in Chapter 2) using a "substantial lessening of competition" or similar test, and others focusing on whether the merger creates or reinforces a dominant market position (e.g. Germany). The European Union recently moved from a pure dominance standard to a standard that includes both elements.

The international round table report and the September 2004 consultation paper highlight the two major enforcement approaches to efficiencies.

- *Efficiencies may be treated as a factor in the analysis of whether a merger is anti-competitive.* Under a factor approach, efficiencies cannot save a merger that is ultimately found to be anti-competitive. However, they may influence the determination of whether the

²⁸ Recommendation 2 is most explicit in that regard: When developing new regulatory frameworks, the federal government should review and adopt international approaches wherever possible.

mergers is in fact anti-competitive, particularly when they “cleanse” the merger of its harmful effects (for example, by increasing rivalry in a market or providing consumer benefits).

- *Efficiencies may be treated as an exception or justification (commonly referred to as a defence) that allows a merger to proceed despite it being found to be anti-competitive. The defence requires a trade-off between the efficiency gains generated by a merger and the merger’s negative effects on competition.*

Jurisdictions where efficiencies are a factor in merger review

In most of the jurisdictions discussed in the international round table report — namely, the European Union, Japan, Mexico, Norway and the United States — efficiencies are treated as a factor in the analysis of whether a merger is anti-competitive, although exactly how this is done varies from jurisdiction to jurisdiction.

European Union

Efficiencies are a factor relevant to the assessment of whether a merger will “significantly impede effective competition ... in particular as the result of the creation or strengthening of a dominant position” (European Commission 2004). To be considered, efficiencies must benefit consumers, for example, by reducing prices, leading to the creation of new or improved products or services, or reducing incentives for coordinated conduct of competitors in a market (European Commission 2004a). The European Commission’s merger guidelines note that the incentive for the merged entity to pass efficiency gains on to consumers “is often related to the existence of competitive pressure from the remaining firms and from potential entry.” The guidelines go on to stress that it is highly unlikely that a merger to monopoly could be approved on the grounds that efficiency gains would be sufficient to counteract its anti-competitive effects (European Commission 2004a, para. 84). Efficiencies must also be merger-specific and verifiable (European Commission 2004a, para. 78).

United States

Efficiencies are considered a factor in the analysis of whether a merger substantially lessens competition. To be considered, efficiencies must be merger-specific and verifiable and must not arise from anti-competitive reductions in output or service (United States 1992). These efficiencies must also be of such a character and magnitude that they reverse a merger’s potential to harm consumers in the relevant market by, for example, preventing price increases in that market (United States 1992). Efficiencies are generally only analyzed for their short-term effects; however, efficiencies with no short-term effect on prices are considered but given less weight (United States 1992, n. 37). Efficiencies almost never justify a merger-to-monopoly or near-monopoly (United States 1992: section 4).

The U.S. Antitrust Modernization Commission is currently reviewing the treatment of efficiencies in U.S. law.

Japan

Efficiencies are considered as part of the analysis to determine whether the merger will substantially restrain competition (Canada 2005, 20).

Mexico

In the overall analysis of a merger to determine whether it will reduce, impair or prevent competition, efficiencies are considered as a pro-competitive effect. To be considered, efficiency gains must be passed on to consumers (Canada 2005, 2–3).

Norway

Norway considers efficiencies as part of the factor analysis of a merger. Under the Norwegian *Competition Act*, special consideration must be given to the interests of consumers; therefore, efficiency gains must benefit consumers in some way to be of decisive relevance in a case. The Norwegian enforcement authority will approve a merger that is likely to result in a price increase and efficiency gains when the merger increases a weighted sum of the consumer surplus and the producer surplus, with more weight being given to consumer surplus.²⁹ In other words, the Norwegian authority takes into account the income transfer that results from the post-merger price increase and acknowledges that the loss of income to consumers should be given more weight than the increase of income to producers. This balancing exercise is complex, and the Norwegian competition authority does not operate with explicit or precise weights.

Jurisdictions with an efficiency defence

Germany

Efficiencies play a limited role in merger review in Germany. The Federal Cartel Agency reviews mergers based on competition criteria. Germany has in place a special authorization process that allows mergers that benefit the economy as a whole. This process is reserved for exceptional cases based on non-competition grounds. To be allowed, a merger must bring benefits that will outweigh the restraints on competition. Efficiencies may be considered to be a public benefit (Canada 2005, 20). Note that the German law only applies to local mergers. The European Commission deals with mergers that meet European law enforcement thresholds using a factor approach.

South Africa

The South African *Competition Act* is similar in many regards to its Canadian counterpart. It is thus not surprising that South Africa shares with Canada an explicit legislative efficiency defence. The South African Competition Commission or Competition Tribunal must consider two things when determining whether a merger that may lessen or prevent competition should be allowed to proceed: whether technological, efficiency or pro-competitive gains are greater than and offset a prevention or lessening of competition; and whether the merger can be justified on substantial public interest grounds. “Public interest grounds” are assessed in light of industrial policy factors. These include the effect that the merger will have on a particular industry or region, employment, the ability of small businesses or firms owned by historically disadvantaged persons to become competitive, and the ability of national industries to compete in international markets. Interestingly, the Competition Commission of South Africa’s comments on the Competition Bureau’s September 2004 consultation paper state that a factor approach to efficiencies would be preferable in Canada, even though South Africa itself has an efficiency defence (South Africa 2004, para. 9).

²⁹ Consumer surplus measures the difference between what a person is willing to pay for a good or service and the amount he or she is actually required to pay. When a merger increases prices the consumer surplus goes down. Producer surplus measures the difference between the price a seller receives and the minimum amount the seller is willing to accept. When a merger increases prices the producer surplus goes up.

Hybrid regimes

In Australia and the United Kingdom, the legislative framework incorporates elements of both the factor and defence approaches.

Australia

Australia's public interest authorization process operates similarly to an efficiency defence in the merger context. The authorization process applies broadly to various types of transactions and trade practices, not just mergers. The authorization process allows the Australian Consumer and Competition Commission (or the Competition Tribunal under proposed changes to the law) to grant immunity to a merger that substantially lessens competition but is found to generate a "net public benefit." The Australian *Merger Guidelines* state that the public benefits most important to merger authorizations are efficiencies (Australia 1999, para. 6.39). Other economic and non-economic (e.g. social, environmental, safety-related) benefits may also be considered. Parties seeking authorization must be willing to subject their merger to public review (registration of the merger, public consultations, publication of the draft public interest decision and, sometimes, conferences).

When parties do not seek authorization, but merely submit their merger for review on the basis that it does not substantially lessen competition, the Commission also considers efficiencies as a factor in its review, but only to the limited extent that those efficiencies would enhance competition in the market following the merger (Australia 1999, paras 5.16 and 5.171). Parties that want to make efficiencies the focus of their merger review are directed to rely on the public interest immunity authorization process — that is, the efficiency defence approach.

United Kingdom

In the normal course of things in the United Kingdom, efficiencies are a factor in the review to determine whether a merger substantially lessens competition. However, they are also separately considered when assessing the customer benefits a merger would generate, and may operate as a form of defence in that assessment.

In the assessment of efficiencies as a factor, only efficiencies with a positive effect on rivalry are relevant (United Kingdom 2003: para. 4.32). Rivalry is seen to be the essence of competition and the means by which benefits to customers are generated. The *Merger Guidelines* state that the Office of Fair Trading must be satisfied that there will continue to be sufficient post-merger rivalry within the market to ensure that the merged entity has an incentive not only to pursue the claimed cost savings but also to pass on to consumers a reasonable share of benefits (United Kingdom 2003: para. 4.34).

When the Office of Fair Trading believes that a merger has, or may be expected to, substantially lessen competition, it has a duty, subject to certain exceptions, to refer the matter to the Competition Commission. The Commission performs its own analysis of whether the merger substantially lessens competition, taking into account various factors, including rivalry-enhancing efficiencies (United Kingdom 2003a: para. 3.27). If the Competition Commission finds that a merger substantially lessens competition it may block the merger or impose remedies.

An exception to the duty of the Office of Fair Trading to refer mergers to the Competition Commission exists when customer benefits (including those generated by efficiencies)

“outweigh both the substantial lessening of competition and any adverse effects of the lessening of competition that follow.” Additionally, the Commission is empowered to take customer benefits into effect when designing a remedy. This means that it may attempt to remedy competition problems while preserving the customer benefits generated (or decline to order any remedy in order to preserve customer benefits, including efficiencies). The Competition Commission’s guidelines explicitly refer to certain types of efficiencies as being consumer benefits (United Kingdom 2003a: paras. 4.41–4.44). These may (in theory at least) serve as efficiencies-based defences when efficiencies give rise to significant customer benefits.

Note that the United Kingdom law only applies to local mergers. The European Commission deals with mergers that meet European law enforcement thresholds using a factor approach.

Treatment of dynamic efficiencies in other jurisdictions

As discussed in Chapter 4, Canada and other industrialized nations are more concerned today about innovation or dynamic efficiency than they were in 1969. Most industrialized countries recognize that innovative capacity and performance are key to economic prosperity.

Given the increasing international focus on innovation, it is not surprising that many merging parties have referred to anticipated improvements in dynamic efficiency as motivating factors for their mergers. Canada’s *Merger Enforcement Guidelines* (both the 1991 and 2004 versions) (Canada 1991, Appendix 2; Canada 2004, para. 8.15) identify dynamic efficiency as one of the two categories of efficiency gains likely to be generated by a merger (the other category being productive efficiencies). The 2004 *Guidelines* include the following commentary on the treatment of dynamic efficiencies in the Bureau’s merger enforcement practice.

The Bureau also examines claims that the merger has or is likely to result in gains in dynamic efficiency, including those attained through the optimal introduction of new products, the development of more efficient productive processes, and the improvement of product quality and service. It is recognized that attaining dynamic efficiency is crucial to both the general evolution of competition and the international competitiveness of Canadian industries. Because dynamic efficiency is extraordinarily difficult to measure, the Bureau generally relies on documents prepared in the ordinary course of business to assess the validity of such claims. Such efficiencies are generally considered from a qualitative perspective (Canada 2004, para. 8.15).

The Panel contacted enforcement authorities in several major jurisdictions to discuss how they consider dynamic efficiency. In general, while all these officials said they would be willing to entertain dynamic efficiency claims in merger review, they added that they would use caution when assessing such claims. For example, claims that a merger will contribute to increased innovation are difficult to quantify and prove. Qualitative analysis of such claims is therefore required. Some enforcement officials pointed out that there is no clear evidence that increased market share or concentration contributes to innovation, and stated that absent evidence of a link, they would be very cautious about giving any material weight to dynamic efficiency claims. They also rejected the notion that dynamic efficiency should be given special treatment in merger review.

Assessment of international regimes

The Panel's review has revealed that there is a wide spectrum of approaches to efficiencies around the world. While the terms *factor* and *defence* refer to broadly similar enforcement approaches, there is significant variation within them, and no two factor or defence regimes are identical. Australia and the United Kingdom incorporate elements of both the factor and defence approaches, yet their regimes are by no means identical. Moreover, contrary to some opinions expressed during the Bureau's consultations, the use of an efficiency defence is not condemned internationally, as evidenced by the fact that a number of major jurisdictions have a defence (or hybrid) regime.

The Mergers Working Group of the International Competition Network has observed that "a merger efficiencies defence appears to be more prevalent in small open-trading economies where domestic markets may not permit a large number of firms to achieve economies of scale" (International Competition Network 2004, para. 19). This would seem to be true in the case of Canada, Australia (hybrid regime) and South Africa; however, there are also very significant differences among the regimes in place in these jurisdictions.

The Panel also notes that some jurisdictions that employ a defence (such as the United Kingdom, which has a hybrid regime) do not fall into the "small open economy" category. The United Kingdom's economy is integrated with that of the broader European Union. The International Competition Network study points out that Brazil and Ireland have forms of the efficiency defence. (International Competition Network 2004: paras. 24–25) Ireland's situation mirrors Canada's to some extent. Ireland is, at least it has become so in recent years, a small open economy at the periphery of a much larger market, in this case the European Union. Brazil is in the situation that Canada was in the late 1960s: it is a trade-oriented country with significant "national champion" industrial policies that may distort the efficiency of the economy.

The Bureau's report on the international round table summarizes comments made by participating jurisdictions on the small market economy argument, as follows.

One participant indicated that putting extraneous considerations in merger review is not appropriate. For example, a "small market" argument, which would support high degrees of concentration, may not be the best way to promote the Canadian economy. In general, high concentration levels and lack of competition is a disservice to any economy on a long-term basis. That participant indicated that competitive markets or markets with rigorous competition are likely to generate the greatest efficiencies. On the other hand, a participant indicated that in the context of a small economy, international competitiveness becomes a relevant element that can be considered in the analysis (Canada 2005, 19).

The International Competition Network's Mergers Working Group concluded that there is no "one size fits all" solution to the treatment of efficiencies in merger review, a conclusion toward which the Panel leans (International Competition Network 2004, 2). At the same time, the Panel favours convergence with the United States, unless there is an objective reason for maintaining a distinct Canadian approach. The Panel's conclusions respecting the regime that is most appropriate for Canada in light of the objective characteristics of its economy are found in Chapter 6.

Chapter 6

Conclusions and recommendations of the Panel

This chapter outlines the Panel's conclusions and recommendations. The first four sections of the chapter outline the Panel's conclusions on the role that efficiencies should play in the administration and enforcement of the *Competition Act* as it applies to mergers. These conclusions are as follows.

- Despite significant changes to the Canadian economy in the last 35 years, Canada still faces a significant productivity problem, and public policy tools, including competition policy, should continue to be used to promote efficiency.
- Mergers can contribute to improvements in the efficiency of firms and the productivity of the Canadian economy; therefore, merger review should involve regular and explicit consideration of the efficiency gains generated by a merger.
- There may be rare circumstances in which competitive market forces have not resulted in firms' optimal efficiency. From a public policy perspective, this could justify allowing a merger that substantially lessens or prevents competition to proceed on the basis that it would produce sufficient offsetting efficiency gains; however, the circumstances in which an efficiency defence may apply, and the applicable standards, should be more clearly defined.
- An efficiency defence should not be permitted in the case of a merger-to-monopoly.

The last section of this chapter sets out the Panel's views on the characteristics that the Canadian competition policy framework should have, in order to ensure that efficiencies are properly addressed. These characteristics are oversight by the Competition Tribunal, accessibility of efficiency gains claims, predictability of outcomes and inclusion of dynamic efficiency as part of the assessment.

This chapter deals only with efficiencies in merger review. The Panel's conclusions and recommendations respecting efficiencies and strategic alliances are found in Appendix A.

Efficiency gains matter and competition policy should encourage efficiency

The specific concerns that led the Economic Council of Canada to advocate an efficiency defence in 1969 may be less salient today, since the tariff barriers protecting Canadian manufacturers have come down significantly and the Canadian economy is one of the most open in the world. For the most part, Canada's manufacturers are competitive and efficient, although there is evidence that Canadian manufacturing plants are smaller on average than their foreign counterparts. Nevertheless, given Canada's productivity gap with the United States and other countries, Canadians should be concerned about manufacturers' efficiency.

Of greater concern is the services sector, in which the productivity gap with the U.S. and with most Organisation for Economic Co-operation and Development (OECD) countries is larger. On average, Canadian service firms are not nearly as big, competitive or efficient as their American counterparts. In addition, a number of important service industries (e.g. banking, telecommunications and media) still operate in a protectionist environment due to foreign ownership restrictions, very much like manufacturing did in the 1960s.

Canada's overall productivity, which is directly correlated with living standards, appears to have been slipping recently, heightening the cause for concern. Several factors contribute to Canada's productivity gap. These include Canada's lower capital intensity, smaller high technology sector and lower investment in human capital relative to the United States and certain other OECD countries, as described in Chapter 3. Many of these factors are beyond the scope of competition policy to correct.

However, competition policy that permits efficiency-enhancing mergers may be able to address, albeit to a limited degree, one of the factors — that is, the smaller average size of Canadian firms. Indeed, most mergers aim to create value through the better use of resources, and thus contribute to efficiency gains. In certain cases, such a contribution may be significant. There is evidence that mergers and changes of control trigger restructuring that contributes to significant productivity gains.

Canada also has an "innovation gap" with other OECD nations, resulting from Canada's and Canadian firms' lower level of investment in research and development. Again, competition policy that permits mergers that would result in dynamic efficiency gains might to a limited degree help close that gap. However, the connection between industry concentration, firm size and innovation varies from industry to industry and within industries. In some cases, concentration has negative effects on innovation and productivity, while it may contribute to innovation and productivity in others. This complex relationship calls for a competition policy framework that allows the impact of mergers on innovation to be considered case by case.

Competition policy is one of several policy tools that may and should be relied on to help the economy (particularly the services sector) improve productivity. Of course, the power of competition policy to promote economic efficiency should not be overstated, as the Economic Council of Canada observed in 1969 (Canada 1969, 197). Competition policy must operate alongside other public policies that promote economic efficiency. Nonetheless, given Canada's efficiency challenges, taken together with the fundamental objectives of the *Competition Act*, which include promoting the efficiency and adaptability of the Canadian economy, the Panel believes that competition policy should encourage efficiency.

Merger review should include regular and explicit consideration of efficiency gains

Mergers and changes of control can contribute to significant gains in productivity. Because mergers have the potential to contribute to such gains, the Panel believes that efficiency gains should be a *regular* and *explicit* consideration in merger review. The Competition Bureau (and the Tribunal in any review of a Bureau decision) should consider any evidence submitted about efficiency gains as part of its assessment of the competitive effects of a merger — that is, when determining whether a merger substantially lessens or prevents competition. In particular, the Bureau should consider whether efficiency gains counter any of the merger's negative effects on competition. This could occur, for example, when efficiency gains serve to increase rivalry in a market, prompt price decreases or create other consumer benefits, such as more innovative products. Both productive efficiency gains and dynamic efficiency gains should be considered in this analysis.

The Bureau's approach should be transparent and consistent, so that merging parties can predict how and whether their efficiency claims are relevant to the assessment of their merger. To this

end, the Competition Bureau's *Merger Enforcement Guidelines* should be explicit regarding the role and importance of efficiencies in the determination of whether a merger substantially lessens or prevents competition. In the longer term, in the interests of legal certainty and consistency, the *Competition Act* should be amended to make it explicit that efficiency gains should be considered in the analysis of whether a merger substantially lessens or prevents competition.

The Panel also expresses its hope that if efficiencies were to become a regular part of merger review, parties would be more willing to bring their efficiency claims forward. As noted in Chapter 2, parties seem to be reluctant to bring forward strong efficiency gains arguments under the current regime, since this may be viewed as an implicit admission that the merger is anti-competitive.

In the context of an application by the Commissioner of Competition to challenge a merger before the Competition Tribunal, the Panel believes that the Tribunal should also consider efficiency gains in the assessment of whether the merger before it substantially lessens or prevents competition.

Canada should maintain an efficiency defence but should better define the applicable standards

The Panel believes that Canada should retain some form of efficiency gains exception, namely an efficiency defence, because in rare but important cases a trade-off between the efficiency gains and a substantial lessening or prevention of competition may be justified. Both productive and dynamic efficiency gains should be considered in this analysis.

There are two principal reasons why the Panel is recommending retaining an efficiency defence. First, the Panel's research has demonstrated that notwithstanding the opening up of trade with the United States and Mexico and the considerable restructuring of the Canadian economy, Canada continues to lag behind the United States and many other OECD countries in terms of overall productivity. The existence of this major productivity gap is an objective reason for giving efficiency gains relatively more weight in Canadian merger law than they are given in the laws of the United States and many other jurisdictions.

Second, the economic evidence demonstrates that the opening of the Canadian economy since 1969 has not resolved the particular challenge of economic efficiency in the Canadian economy. The economic evidence reviewed by the Panel demonstrates that, while firms in the goods-producing sector are for the most part holding their own against foreign competitors, manufacturing firms are still smaller on average in Canada than their counterparts in other countries, that some trade barriers remain (e.g. in the agricultural sector and in industries that face competition from exporters in non-NAFTA countries where meaningful tariffs remain) and that border effects are an important factor protecting Canadian firms from the full brunt of international competition.

The evidence is particularly clear in the services sector, which lags significantly behind that of the U.S. and other countries in terms of productivity and accounts for the lion's share of Canada's productivity gap. The reasons for the relatively lower productivity of the Canadian services sector are manifold. One contributing factor is the continued existence of foreign ownership and other regulatory restrictions in "strategic" sectors (including banking, telecommunications, media, book selling and air transportation). By definition, these foreign

ownership and entry restrictions limit not only competition in the Canadian market but also the ability of Canadian firms to merge with their domestic counterparts. Another factor is the smaller size of Canadian service firms in general. The Panel believes that in industries in which competitive forces have not led to the creation of efficient firms and markets, other mechanisms should be considered in order to improve efficiency, including allowing mergers that significantly reduce competition but that also generate sufficient efficiency gains.

Conceptually, an efficiency defence may be justified when a merger causes the combined entity to increase its overall efficiency, moving it closer to global standards, as was shown in Chapter 3 with the inverted-U relationship. However, the circumstances that would lead to an industry being structured such that firms are constrained to operate below the optimal point are probably rare, since market forces normally push an industry to operate at its most efficient level. In such circumstances, the scale of firms is smaller than optimum. This is the effect that the Economic Council attributed to tariffs in the 1960s. Today, border effects and, in some sectors, restrictions on foreign entry and foreign competition, may be having the same effect (although the Panel does not wish to restrict the application of a trade-off just to the so-called "constrained" sectors identified in Chapter 3).

The Panel believes that the situations in which increased concentration would be associated with efficiency gains of such a magnitude that they would offset a lessening of competition (and the trade-off would thus generate social benefits) would be rare. However, the existence of an efficiency trade-off as a policy tool that could be used in special circumstances is consistent with the unique features of the Canadian economy. These features include its size, its geographical trade patterns and the numerous public policies that act upon the economy and give it its own unique structure.

The Panel emphasizes that its recommendation that an efficiency defence be retained does not mean that concentration should trump competition. To mount a successful defence, it would be necessary for the merging parties to demonstrate that the benefits of a merger (the efficiency gains) outweighed the costs of the merger (the harm to competition in the industry). The Panel's overall impression is that an efficiency defence would and should only apply rarely.

The Panel believes that the Competition Bureau should take into account the strength of the merging parties' efficiency claims and the likelihood that a trade-off is justified when deciding whether to challenge a merger before the Competition Tribunal. This is because public funds should not be spent litigating a case in which the efficiency gains would justify the merger. When there is genuine concern about whether the efficiency gains justify the merger, the Competition Tribunal should be the independent arbiter of the matter.

The Panel recognizes that in some protected sectors a specialized regulator may also exercise merger review powers. However, except in very limited circumstances the Competition Bureau also has jurisdiction to review mergers in regulated industries. The Panel is firmly of the view that when the Bureau reviews such mergers it should address *both* the effects of the merger on competition *and* the efficiency gains the merger generates, including whether the efficiency gains offset any negative effects on competition. Indeed, the evidence demonstrates that foreign ownership and regulatory restrictions contribute to the lower productivity of the Canadian economy, which means that the Bureau's assessment of the degree to which a merger in a regulated industry contributes to efficiency gains is critically important.

In 1969, the Economic Council advocated the use of competition policy to promote efficiency because it was unable to directly address the principal source of inefficiency in the Canadian economy — namely, tariffs. Today, tariffs are no longer a major concern, but numerous other public policies and regulations have the effect of shielding certain industries from competition in the same way that tariffs protected industries in 1969. One might question whether many of these regulatory restrictions continue to serve the public interest, given their negative effects on the efficiency of the Canadian economy; however it did not fall within the Panel's mandate to examine these matters. The Panel was only asked to address the issue of how efficiencies should be treated under the *Competition Act* and, in this regard, has concluded that in rare cases it may serve the public interest to allow a merger that creates sufficient offsetting efficiency gains, even when that merger substantially lessens or prevents competition. As stated previously, the Panel believes that an efficiency defence may be justified in any sector — regulated or not — when barriers of some sort maintain it below its optimal efficiency point.

The Panel is not satisfied with the current standard, resulting from the Superior Propane case, for weighing efficiency gains against anti-competitive effects. At present, the *Competition Act* is silent on the issue of the standard. The Federal Court of Appeal in the Superior Propane case endorsed a standard called "balancing weights" as one possible standard that would meet the Court's requirements to weigh efficiency gains against effects, measured in light of all the purposes of section 1.1 of the Act. However, many view this standard as cumbersome and unpredictable. The Panel agrees. Applying the balancing weights standard is highly complex, since it requires the Competition Tribunal and the Competition Bureau to determine whether there are any adverse effects of the redistribution of wealth resulting from a merger. It also requires them to do a "weighted" balancing of efficiencies against effects, with weights that may vary from case to case. Moreover, the Federal Court suggested that while the balancing weights standard met its requirements, "the same standard may not be equally apposite for all mergers" (*Superior Propane*, first appeal, para. 140). As a result, it may not even be clear what standard applies to a particular merger. It is the Panel's opinion that there should be a clear, predictable and politically acceptable standard that the Tribunal applies when weighing efficiency gains against anti-competitive effects.

The Panel is of the view that Parliament should define, in clear terms, the standard that any trade-off would have to meet, since this is fundamentally a policy question of who should benefit from the efficiency gains of an otherwise anti-competitive merger. Specifically, the issue of the standard bears on how the Tribunal should take into account the negative impact of a lessening of competition on one segment of the Canadian population (i.e. customers) when assessing the benefits that efficiency gains may bestow on other segments.

The Panel also stresses the importance of ensuring that the existence of an efficiency defence, which is likely to apply rarely, does not detract from the Bureau and Tribunal regularly considering pro-competitive efficiency gains when assessing the competitive effects of a merger. In other words, parties should not be required to invoke the defence in order to have their evidence of efficiencies considered. Efficiencies should be a regular consideration in the assessment of whether a merger substantially lessens or prevents competition, to the extent that they are relevant to that assessment. The Panel does not recommend incorporating industrial policy concerns, such as import substitution or export enhancement (currently found in section 96(2) of the Act) in the efficiency trade-off. Nonetheless, it should be clear, as it is under the current law, that efficiency gains and effects outside Canada are not to be taken into account

as part of the trade-off (*Superior Propane*, redetermination decision of the Competition Tribunal, paras. 196–198).

The efficiencies defence should not be used in merger-to-monopoly situations

The Superior Propane case had the paradoxical result of authorizing a merger that led to a near-monopoly. The irony of having the *Competition Act* justify a monopoly was not lost on most observers. An efficiency defence should not apply in cases in which a merger leads to the creation of a monopoly. The Panel believes that monopolies inevitably lead to a loss of productive efficiency. This is in addition to the loss of allocative efficiency (deadweight loss) resulting from the higher post-merger price of the monopoly's products or services (although this can be prevented with the proper regulations). Given that evidence suggests that competitive pressure contributes both to efficiency in general and to dynamic efficiency in particular, it would be inappropriate to allow efficiency gains to justify a merger when competitive pressure was all but removed. Among other things, the Panel notes that serious concerns respecting x-inefficiency may arise when a merger leads to a monopoly.

The traditional theory of the firm asserts that in monopoly situations shareholders reap the additional benefits that come from restricting demand and shrinking consumer surplus. The agency theory of the firm, in contrast, argues that management is in a position to intercept a portion of these benefits and use it for its own welfare.³⁰ As a result, x-inefficiency increases and resources are misallocated. There is significant evidence in the literature that correlates low productivity and monopolies. The OECD recently looked at Canada's utilities, which are mostly regulated monopolies, and concluded that they make a significant contribution to the lower efficiency of the Canadian economy (Maher and Shaffer 2005).

While there may be circumstances in which allowing a merger to proceed based on an efficiency gains trade-off may contribute to a lasting improvement in efficiency, a merger-to-monopoly will generate its own inefficiency in the long run. Although this can be difficult to measure and although parties may argue that inefficiency will not occur in their specific case, the eventual efficiency losses resulting from the absence of competitive pressure are likely to be significantly larger than any short term gains in efficiency resulting from the greater scale or scope of the merged entities. The Panel therefore believes that a trade-off between efficiency gains and competitive pressures is acceptable, but not when competitive pressure is completely or almost completely eliminated.

The Panel notes that numerous participants in the Competition Bureau's recent consultations expressed concerns about whether and how *monopoly* can be legally defined. While there are differences of degree, the Panel does not consider the term *monopoly* to be *qualitatively* different from other terms used in the Act, such as *substantial lessening or prevention of competition* (used in the merger provisions), *undue lessening or prevention of competition* (used in the conspiracy provision) or *substantial or complete control of a class or species of business* (used in the abuse of dominance provision). All of these terms have been defined through enforcement practice and case law. *Monopoly* can also be so defined.

³⁰ See Jensen and Meckling (2000) for a synthesis of the agency theory of the firm, in what is one of the most quoted economic papers on this topic.

The Panel notes that some of the competition law bills debated in the 1970s (C-42 and C-13, 1977) contained language that would have prevented the efficiency defence from applying in situations in which a merger would have led the merging parties to enjoy "virtually complete control ... in respect of a product in a market," which seems to the Panel to be something akin to a bar on the use of an efficiency gains defence in a merger-to-monopoly situation. Thus, while the Panel acknowledges that it may be challenging to draft an enforcement policy or legislative or other provision limiting the efficiencies trade-off to situations in which a merger does not create a monopoly, it does not think that the drafting challenges are insurmountable.

Other characteristics of the framework for treating efficiency gains

The Panel's mandate requires it to express its views on "the characteristics that the Canadian competition policy framework should have, in order to ensure that efficiencies are properly addressed." A number of these characteristics (e.g. regular consideration of efficiency gains by both the Competition Tribunal and the Competition Bureau) are discussed above. Others are set out below.

The Panel has made no attempt to list all possible characteristics of an effective regime. Rather it has focused on those it views as most important based on its economic analysis and in light of the general public policy and business experience of the Panel members. A number of these desirable characteristics are already present, to a lesser or greater degree, in the current legislative regime.

Competition Tribunal oversight. It is not within the Panel's mandate to comment on the mechanism by which mergers may come before the Competition Tribunal. Whatever the mechanism, the Panel believes that the Tribunal's power to conduct its own review of the efficiency gains generated by a merger is critical to maintaining the integrity of the system. Given the complexity of many of the issues around efficiencies, a "sober second look" by an independent third party such as the Tribunal is well justified. The Tribunal's review function would be even more important under the framework the Panel proposes, since the Competition Bureau would more regularly assess efficiency gains claims. Oversight by the Competition Tribunal has contributed and should continue to directly contribute to the quality of these assessments.

Accessibility. The efficiency defence in section 96 has rarely been invoked or applied. One major concern with the current framework is that firms are required (or consider that they are required) for all practical purposes to admit that their merger substantially lessens or prevents competition in order to invoke the defence. Parties must (or consider that they must) be willing to litigate the matter if they raise the defence. As outlined above, the Panel believes that parties should be able to bring their efficiency gains claims to the Competition Bureau at the outset of a review. In doing so, parties should not be assumed to be explicitly or implicitly admitting that their merger creates a competition problem. There should be no requirement that parties be willing to litigate when they want the Bureau to fully consider the efficiency gains, either as a defence or in the determination of whether their merger substantially lessens or prevents competition (although the Tribunal should retain its review function over these matters).

Predictability. Businesses and their advisors consider it critically important that they be able to predict with some degree of certainty the likely outcome of a Competition Bureau merger review. Based on its assessment of both the report of the international round table and the

submissions made in response to the Bureau's September 2004 consultation paper, the Panel believes that the "balancing weights" standard adopted in the Superior Propane case lacks basic predictability. While it is true that additional case law and/or enforcement guidance in the area could improve the situation, the Panel sees legislative intervention as a more direct and effective route to improving predictability. In addition, the Panel believes that it will be very important, if and when a new regime is adopted, for the Competition Bureau to publish clear administrative guidance, such as that in the *Merger Enforcement Guidelines*, about how it intends to approach efficiencies in merger review.

Assessing dynamic efficiency. The federal and provincial governments have policies in place to promote innovation, and dynamic efficiency gains are a means to achieving innovation. However, merger-related claims for such gains are difficult to assess, although there is no doubt that some mergers in the past have yielded them. In part, this is due to the relatively long time frame over which such gains may appear. Thus, while competition policy should recognize dynamic efficiency claims, measurement problems preclude such claims being given special weight or time frames in merger reviews. The current Canadian practice of doing a qualitative assessment of claims of dynamic efficiency is appropriate and consistent with international practice.

Appendix A

Efficiency gains and strategic alliances

The Panel's mandate suggested that Panel members "may wish to consider the applicability of their findings to the treatment of efficiencies in the context of strategic alliances and other trade practices." This appendix briefly explores the current treatment of strategic alliances under the *Competition Act* and also describes the role of efficiencies in the context of strategic alliances.

The Panel regards strategic alliances as being very similar to mergers, since a strategic alliance is also a form of business combination. The Panel's general conclusion is that the regime for dealing with efficiency gains in strategic alliances should be identical to that in place for mergers.

Current treatment of strategic alliances under the Competition Act

The *Competition Act* does not use or define the term *strategic alliance*. Business people commonly use it to describe an agreement or arrangement between two or more persons to undertake a specific business or project. Strategic alliances may be structured as mergers or as purely contractual arrangements.

The definition of *merger* in section 91 of the *Competition Act* is very broad. It applies to any manner in which one business acquires control over or a "significant interest" in another business. The term *significant interest* is not defined in the Act, and has been interpreted to apply to a range of business relationships that involve one party obtaining the ability to materially influence the economic behaviour of another, including some strategic alliances (Canada 2004b, para. 1.5). In some circumstances, a purely contractual relationship between two or more business parties may be viewed as a merger for competition law purposes (Canada 2004b, paras. 1.12–1.13).

When a strategic alliance is structured as a merger, it may be reviewed like any other merger and so the efficiency defence may apply. The Panel's recommendations respecting the appropriate framework for the treatment of efficiency gains in the merger review context set out in Chapter 6 extend by definition to any strategic alliance that is structured or reviewed as a merger.

Strategic alliances also come up in the context of Canada's criminal conspiracy law, section 45 of the *Competition Act*. The PANS case (*R. v. Nova Scotia Pharmaceutical Society*) is the leading case respecting the interpretation of section 45. In it, the Supreme Court of Canada identified three elements of the offence under section 45:

- the accused, in fact, entered into an agreement;
- the agreement prevents or unduly lessens competition; and
- the parties intended to enter the agreement, were aware of its terms and were aware or should reasonably have been aware that their agreement was likely to prevent or unduly lessen competition.

Any agreement between two or more parties, such as a contractual strategic alliance, may potentially be caught by this provision — although few are — if the agreement is found to unduly prevent or lessen competition. This may occur, in particular, when the parties collectively

hold a large share of the market and are found to have market power and when the agreement restricts competition. The offence of conspiracy is complete when an agreement is reached, whether or not it is actually implemented.

Canada's conspiracy law has been criticized as being "under-inclusive," since it is very hard to prove intent and undue effect, even in the case of hard-core cartel conduct, such as price fixing. At the same time, section 45 has been criticized as being "over-inclusive," since it applies, at least in theory, to all horizontal arrangements, and it has been argued that section 45 may deter the formation of pro-competitive, efficiency-enhancing arrangements.

In recent years, there have been numerous calls to reform section 45. In June 2003, the Competition Bureau published a discussion paper that included proposals to limit the criminal conspiracy provision to hard-core cartels (Canada 2003: 17). Under these proposals, the Competition Tribunal could review horizontal and vertical arrangements that prevent or substantially lessen competition, or are likely to, but that are not covered by the criminal conspiracy provision. It was suggested that efficiencies become a factor to be considered when determining whether an alliance substantially lessens or prevents competition, along with other factors, similar to those listed in section 93.

Public consultations about the appropriate model for section 45 were launched with the June 2003 discussion paper, and the Bureau's assessment of whether section 45 needs to be amended, and how, is ongoing.

Efficiencies generated by a strategic alliance are not a defence or even a consideration under section 45. This is because the Supreme Court of Canada found in the PANS case that "private gains by the parties to the agreement or counterbalancing efficiency gains by the public [...] lie outside of the inquiry under s. [45(1)(c)]" of the *Competition Act*. The Supreme Court reasoned that the *Competition Act* presumes that an undue lessening or prevention of competition is an injury to the public and is not concerned about public injury or public benefit from any other standpoint (pp. 640–650).

In summary, efficiency gains are only considered under the current law when strategic alliances are reviewed as mergers under the general merger review framework. Efficiencies are not a defence or even a consideration when alliances are reviewed as potential conspiracies. That this is so does not necessarily imply that large numbers of efficiency-enhancing agreements are being prevented, since the vast majority of contractual strategic alliances do not raise any issues under section 45.

Conclusions

In 1995, the Competition Bureau published the *Strategic Alliances Bulletin*, which outlined its views on the circumstances in which a strategic alliance might contravene section 45 or raise other issues under the *Competition Act*. In that document, the Competition Bureau recognized the following.

A growing number of firms have turned to strategic alliances as a means of improving their competitiveness in an age of increasing international competitive pressures, the globalization of markets, and generally decreasing trade barriers (Canada 1995, 2).

The use by Canadian firms of strategic alliances to improve their competitiveness should generally lead to positive innovation and efficiency gains without accompanying negative effects on competition (Canada 1995, 3).

The Bureau's general enforcement position under the *Strategic Alliances Bulletin* was that most strategic alliances do not raise concerns under the *Competition Act*. In 2002, the Bureau invited comments on how it should clarify the *Strategic Alliances Bulletin* to ensure that the conspiracy provision did not place a "chill" on pro-competitive and beneficial strategic alliances, pending the reform of section 45 (Canada 2002c).

The Panel recognizes that strategic alliances can be an important way for firms to improve their efficiency and competitiveness. The Panel therefore believes that efficiency gains should be considered in the assessment of strategic alliances under the *Competition Act*. In terms of the model that should apply, the Panel sees no principled reason to distinguish between the efficiency-enhancing aspects of mergers and those of strategic alliances. Strategic alliances and mergers are simply two ways in which businesses can combine their operations. For the purposes of assessing any pro-competitive efficiency gains, the Panel believes the same framework should apply to both strategic alliances and mergers.

The Panel recognizes that, in light of the Supreme Court's judgment in the PANS case, efficiencies do not arise under the current criminal conspiracy provisions. However, if a civil strategic alliances provision along the lines of that proposed in the June 2003 discussion paper were to be adopted, it should incorporate a framework for assessing efficiency gains identical to that for mergers. The elements of the framework recommended by the Panel are described in Chapter 6.

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